Doing good and doing well: ESG trade-offs in investing

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IN BRIEF

- Interest in sustainable investing is growing globally, driven by investors trying to increase risk-adjusted returns (“doing well”) and support sustainable outcomes (“doing good”).
- Our analysis finds no meaningful trade-off between doing good and doing well when investing in public markets. Given that environmental, social and governance (ESG) investing does not come at a cost in terms of performance, it can be seen as a “free option” to align portfolios with investors’ values, as well as to prepare portfolios for the impacts of potentially tighter environmental or social regulation.
- However, investors should avoid introducing biases into their strategic asset allocation to achieve sustainable outcomes.
  - Rather than tilting toward regions with higher ESG scores, investors should identify sustainable companies in each region.
  - Similarly, investors should not be discouraged from investing in private markets due to a lack of ESG data. Identifying sustainable leaders in private markets can help achieve sustainable outcomes.
- We see value in a two-step approach: choosing an optimal asset class mix based on traditional measures of risk and return, and tilting the portfolio toward ESG leaders or “improvers” within each asset class.

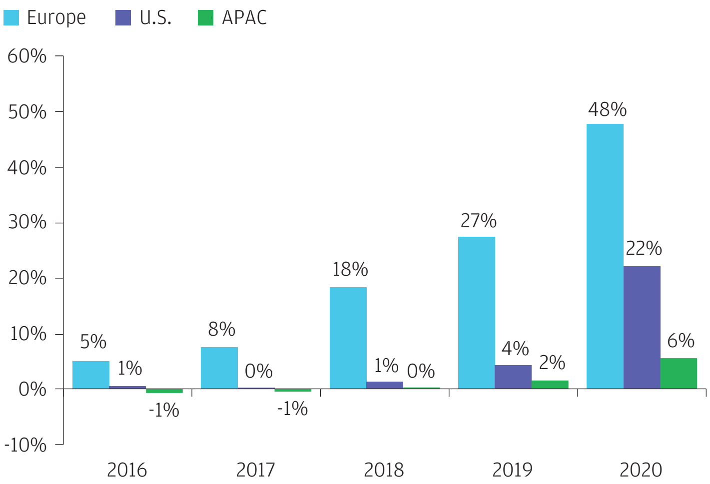
J.P.Morgan Asset Management

INVESTORS ARE INCREASINGLY TURNING TO ESG INVESTING TO BOTH "DO GOOD" AND "DO WELL"

Interest in sustainable investing is growing globally among a wide range of market participants (**EXHIBIT 1**). Some investors have long been motivated by environmental or societal objectives. Others seek financial opportunities in the companies that stand to benefit from rapid changes in consumer preferences, policy and regulation, spurring further interest in sustainable investing.

Interest in sustainable investing is rapidly rising

EXHIBIT 1: FLOWS INTO SUSTAINABLE STRATEGIES AS PERCENTAGE OF TOTAL INFLOWS BY REGION



Source: Morningstar, J.P. Morgan Asset Management; data as of June 30, 2021.

What are the choices and trade-offs investors face as they integrate environmental, social and governance (ESG) risks and opportunities into multi-asset portfolios?

In general, investors tend to consider ESG factors either to increase risk-adjusted returns ("doing well") or to achieve sustainable outcomes ("doing good"). Our analysis finds no meaningful trade-off between doing good and doing well when investing in public markets. A sector-neutral equity portfolio is not hindered, relative to its benchmark, by a skew toward ESG leaders (defined as companies that perform well on J.P. Morgan Asset Management's ESG scoring framework).

In fixed income, while there is evidence that higher ranked ESG issuers pay lower coupons, investors are likely to be compensated with lower default risk. Total return results will vary depending on which of the many ESG rating systems are being used. Across both equities and fixed income, choosing an ESG rating system that produces reliable ESG "scores" is a critical choice in sustainable investing.

Investors who want their portfolios to have a minimum ESG score might be tempted to avoid certain markets or regions, such as the emerging markets. However, our analysis shows that because of the wide variation of scores in every region, a better portfolio solution is one that optimizes first on region and then within a region on ESG score.

Similarly, investors should not be discouraged from investing in private markets just because ESG data can sometimes be harder to obtain. Indeed, turning away from private markets can be a real loss because these markets are increasingly providing portfolios with solutions for attaining income, diversification and alpha. ESG information can be less transparent in private markets, requiring more research and investigation. But investment in private markets not only can help achieve return objectives, it is also likely to be essential for achieving sustainable outcomes as private markets grow in size and importance.

Investors may again wish to adopt a two-step approach: first, choosing an optimal mix of asset classes based on traditional measures of risk and return, and second, tilting the portfolio toward ESG leaders or "improvers" within each asset class. (That second step is more difficult in private markets.)

EQUITIES: ESG IS NOW WELL ESTABLISHED AND CARRIES NO OBVIOUS COST

Tilting portfolios toward better ESG names in equities does not require sacrificing returns vs. a benchmark. Whether tilting portfolios toward ESG leaders can deliver sustainable alpha is a subject of spirited debate, with extensive research making the case both for and against.

There are two channels through which sustainable business practices can help companies outperform their peers and generate higher returns for investors. The first channel is market forces, where the costs of nonsustainable practices play out and can hurt a company, either because it suffers the effects of regulation (e.g., carbon emissions-related taxation) or because it fails to meet consumer preferences (perhaps inspiring a boycott of businesses with poor labor practices). This market forces effect should be persistent through time.

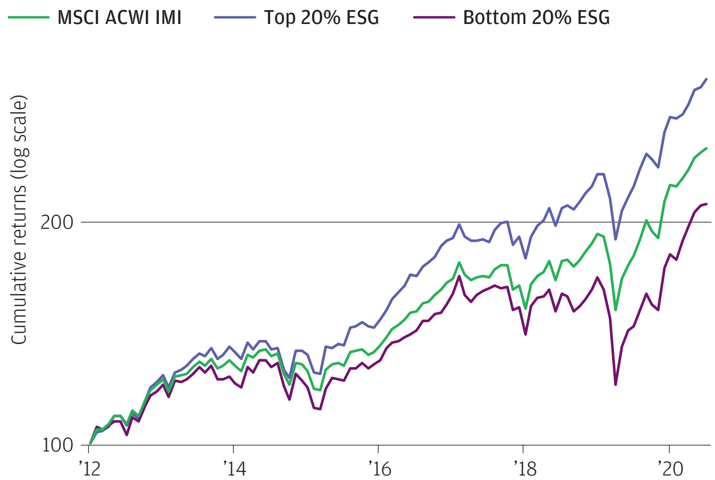
The second channel is via increased demand (and thus higher prices) for these companies' shares relative to their lower scoring peers. This "repricing" effect should be transient as market participants price in ESG considerations more accurately.

EXHIBIT 2 provides an illustration of how ESG screening can affect performance. Based on our J.P. Morgan Asset Management ESG scores, we find that a strategy that is sector neutral and invests in the 20% best ESG companies would have outperformed the benchmark MSCI All-Country World Index (ACWI) by 2.5% per annum, on average, over this period. Conversely, skewing the portfolio toward the bottom 20% ESG companies would have resulted in it underperforming the benchmark by 1.8% per annum. This is over a period when we have seen increased demand for sustainable assets. While we therefore hesitate to use them as evidence that ESG is generally additive to performance, these numbers do give us confidence that ESG investing does not harm performance.[1] The finding that ESG investing does not harm performance is consistent with a large number of other studies.[2]

Put differently, we should not think of modern ESG investing as restricting investors' choice set (e.g., by excluding entire sectors) in a way that is bound to harm performance. Instead, it can be a way of incorporating additional information on potential long-term opportunities (e.g., electric vehicles) into the security selection process. In areas where these opportunities are already starting to be priced in, this can be seen in today's risk-return characteristics.

There is no evidence that investing in ESG leaders harms performance

EXHIBIT 2: TOP ESG SCORING COMPANIES VS. WORST SCORING, PERFORMANCE RELATIVE TO BENCHMARK



Source: J.P. Morgan Asset Management; data as of June 30, 2021.

One common refrain about ESG investing is that ESG is simply "the quality factor in disguise" – and that the performance characteristics of ESG investing reflect an exposure to quality stocks. A company with a strong management team is likely to be more profitable than its industry peers and also to have more robust governance arrangements. As a result, it would score better on traditional quality indicators such as return on equity (ROE) as well as on the "G" of ESG. Similarly, companies with good human capital management practices (like high levels of employee engagement and satisfaction) may have a competitive advantage and higher ROEs,[3] along with being more sustainable than their peers.

1 In addition to occurring over a period that saw significant inflows into sustainable strategies, the outperformance we find in our back-test is not statistically significant.

2 Ulrich Atz, Zongyuan Zoe Liu, Christopher Bruno, and Tracy Van Holt, "Does Sustainability Generate Better Financial Performance? Review, Meta-analysis, and Propositions", Working Paper, 2021

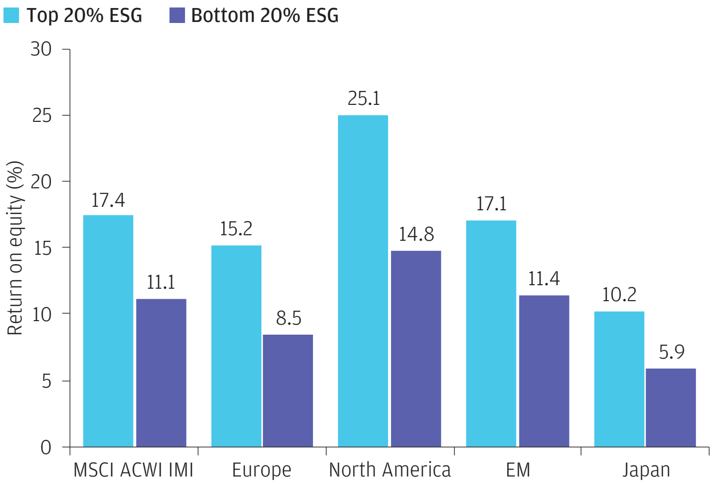
3 Alex Edmans, "Does the stock market fully value intangibles? Employee satisfaction and equity prices", *Journal of Financial Economics* 101, no. 3: 621-640, 2011, and Woocheol Kim, Judith A. Kolb and Taesung Kim, "The Relationship Between Work Engagement and Performance: A Review of Empirical Literature and a Proposed Research Agenda," *Human Resource Development Review* 12, no. 3: 248-276, 2012.

This overlap between ESG and the quality factor can be seen in the quality characteristics of the ESG portfolios below. The higher scoring ESG portfolio provides both higher profitability and somewhat lower volatility than the lower scoring ESG portfolio (**EXHIBITS 3** and **4**). It means that investors can "do good" while also benefiting from any return potential that is associated with traditional indicators of quality.

ESG analysis that results in a score typically focuses on companies' current ESG profile. Current ESG leaders may outperform due to a repricing effect or if changes in the regulatory and consumer landscapes significantly impact their future earnings. Though it is not possible to test due to a lack of historical data, it is possible that there are alpha opportunities in investing in companies that are moving up the ESG scale, particularly those that other investors have missed. A forward-looking approach to scoring a company is inherently difficult but will most likely capture those businesses that can do good and do well. This underscores the importance of active management even in the presence of third-party ESG scores.

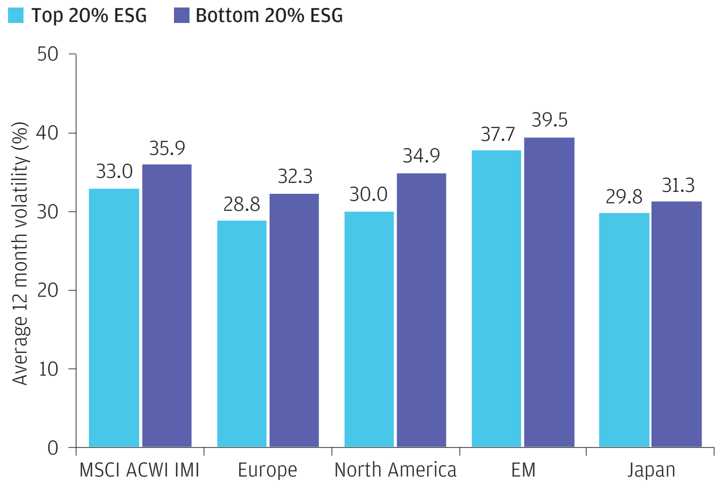
Higher scoring ESG companies are significantly more profitable, and their stocks a little less volatile, than their lower scoring peers

EXHIBIT 3: AVERAGE ROE OF THE BEST AND WORST ESG COMPANIES



Source: J.P. Morgan Asset Management; data as of June 30, 2021.

EXHIBIT 4: AVERAGE 12-MO VOLATILITY OF THE BEST AND WORST ESG COMPANIES



Source: J.P. Morgan Asset Management; data as of June 30, 2021.

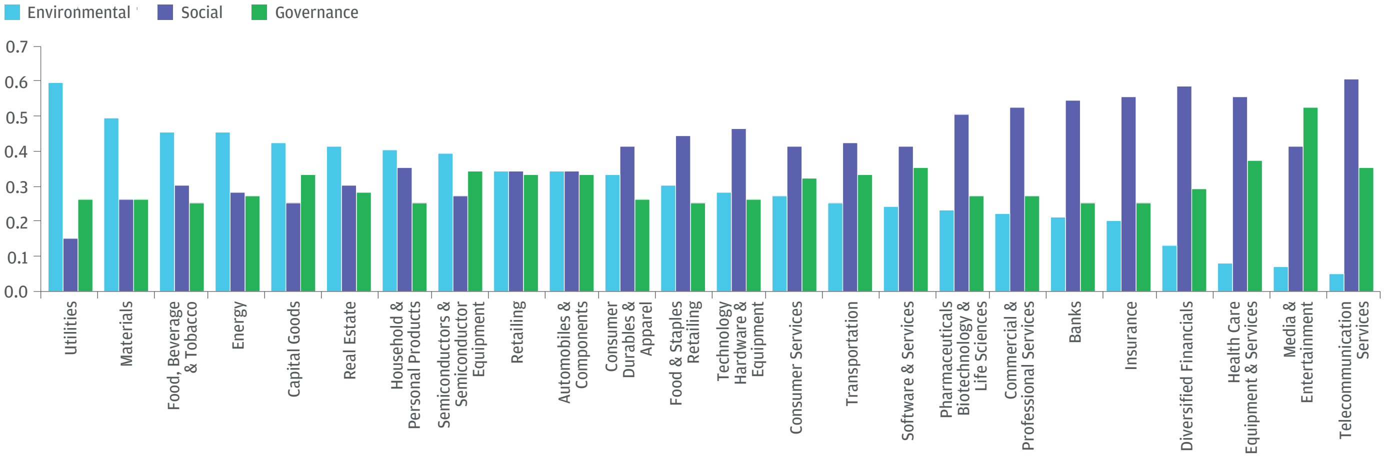
WHAT ARE GOOD ESG PRACTICES?

One of the challenges that investors face is how to identify good ESG companies, given the ambiguous definition of what constitutes "good" ESG practices.[A]

In addition, the sustainability issues that will materially impact a business vary significantly across industries. The scoring system that J.P. Morgan Asset Management uses places a different weight on each of the three pillars (E, S and G) depending on the industry and region (**EXHIBIT B1**).

Our scoring system focuses on the issues that matter most for a given industry

EXHIBIT B1: WEIGHTS PLACED ON E, S AND G BY INDUSTRY BY J.P. MORGAN'S PROPRIETARY ESG SCORE



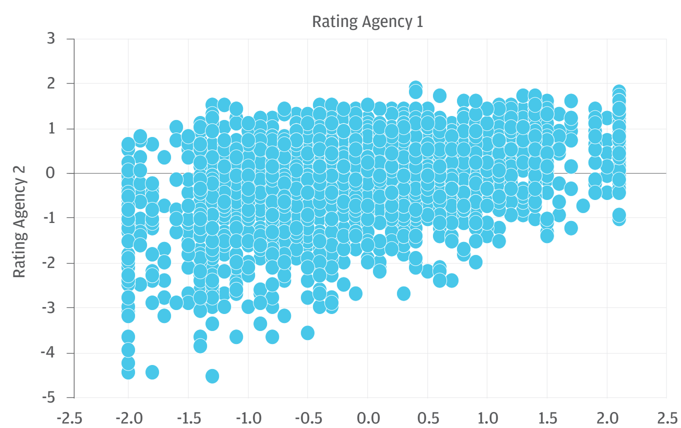
Source: J.P. Morgan Asset Management; data as of June 30, 2021.

As part of our work to continuously expand and refine our sustainable investment framework, we are also developing a new, proprietary tool for making data-driven ESG assessments. This tool makes use of the increasing availability and comparability of granular, firm-specific ESG information, such as greenhouse gas emissions volume, gender diversity or patents on green technologies.

In contrast, existing third-party scores tend to be more heavily driven by exposure assessments (the risks we would expect to see based on a company's industry or geographic footprint) or business controversies (issues companies were criticized for in the past). There is also the risk that established rating methodologies may focus too much on ESG factors that mattered in the past, not those that will likely become important in the future.

EXHIBIT B2 shows the scores available from external providers and notes that there is extensive disagreement among even the largest ESG score providers. For example, a score of -2 from Rating Agency 1 coincides with a range of -4.5 to +1 from Rating Agency 2. More generally, we observe significant dispersion in ESG rating agencies' scores: Correlations tend to be below 50%, compared with over 90% for credit ratings. This lack of consensus can be attributed to each rating provider's discretion in how it uses inputs at each stage of constructing an ESG score, including which issues to consider, which metrics to use to characterize a corporate practice and which peer group to measure each company against.

EXHIBIT B2: RELATIONSHIP BETWEEN MSCI AND SUSTAINALYTICS HEADLINE ESG SCORES



Source: MSCI ESG Research, Sustainalytics, J.P. Morgan Asset Management; data as of June 30, 2021. Normalized ESG scores for a sample of ~2,500 companies in MSCI ACWI.

[A] Interestingly, one study found that greater ESG disclosure actually led to greater ESG rating disagreement. Given the lack of agreement on ESG metrics to assess a firm's ESG performance, greater disclosure led to increased subjectivity and therefore more disagreement among ESG rating providers. (George Serafeim and Aaron Yoon, "Stock Price Reactions to ESG News: The Role of ESG Ratings and Disagreement," Harvard Business School Working Paper 21-079, October 2020.)

FIXED INCOME: ADDITIONAL NUANCE

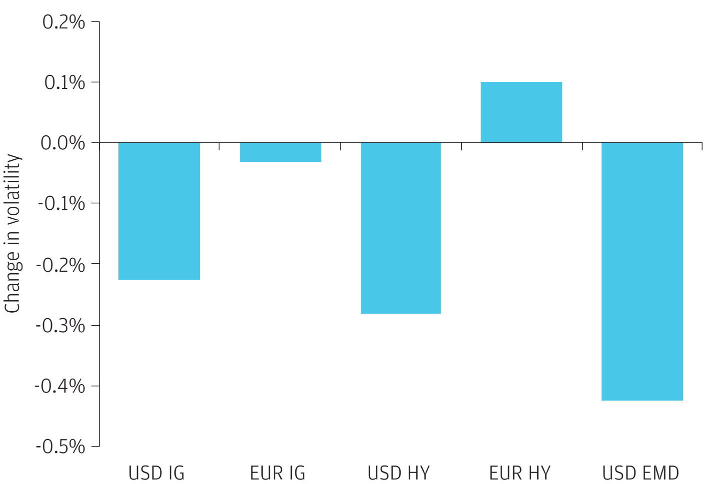
The different position of bond investors in the capital structure means they will always look at ESG through a slightly different lens than equity investors. In particular, they have strong financial incentives to avoid any downside risks that are associated with unsustainable business models.

The rising availability of corporate ESG scores allows for robust ESG assessments of corporate credit. Yet fixed income markets have lagged equities in the application of ESG criteria. This likely reflects a range of factors. Among them: Bondholders do not have any control rights; bonds may be issued by subsidiaries, for which it is more difficult to obtain relevant data; and the shorter maturity of corporate debt means that some long-term considerations are less financially material. Still, recent years have seen a very significant increase in the role of ESG in fixed income.

In one analysis of the trend, a study done by J.P. Morgan Asset Management found that credit portfolios tilted toward top-scoring ESG companies had marginally better excess returns when compared with a non-ESG benchmark.[4] More importantly, these tilted portfolios experienced lower drawdowns, which can improve overall portfolio volatility (**EXHIBIT 5**). Moreover, credit ratings often fail to capture the information contained in ESG scores, highlighting the benefits that ESG scores can provide in security selection.

A tilt toward higher ESG scores can improve overall portfolio volatility

EXHIBIT 5: VOLATILITY OF ESG CORPORATE BOND PORTFOLIOS RELATIVE TO RELEVANT BENCHMARK



Source: ICE BofAML, MSCI ESG Research, J.P. Morgan Asset Management. IG: investment grade; HY: high yield; EMD: emerging market debt. IG data are 2007–19 averages; HY and EMD cover 2013–19. The 2019 figures are first quarter, annualized.

Sovereign bonds

Market participants are increasingly interested in assessing the sustainability characteristics of sovereigns. While there is abundant country-level ESG data, the challenge is what to do with this information. Countries with higher per capita incomes tend to have stronger institutional and regulatory structures and thus tend to score better on ESG metrics than developing nations.

A shift away from low income countries would reduce financial risk and may help investors "do well." But to "do good," investors may instead want to engage with those countries that have credible plans to improve and would benefit from financing environmental or social initiatives.[5]

Green bonds

Sustainable and "green" bonds make up another market segment that has attracted rising interest. These securities' ESG credentials arise not from the bond issuer but from the use of the proceeds (typically for sustainable projects). Yet it is often difficult to assess the credibility of the use of the proceeds. These securities may be most appealing to investors who want to "do good" and see their money support sustainable outcomes.

Such bonds increasingly trade at a systematic premium ("greenium") and thus a lower yield even when issued by the same entity. This most likely testifies to the strength of demand relative to supply. While yields will be relatively lower, total return could be bolstered by further repricing effects as demand for ESG instruments continues to grow. In addition, investors need to consider the potentially lower default risk of green bonds compared with bonds by other issuers.

4 Bhupinder Bahra and Lovjit Thukral, "ESG in Global Corporate Bonds: The Analysis Behind the Hype," *Journal of Portfolio Management* 46, no. 8: 133–147, 2020.

5 "A New Dawn: Rethinking Sovereign ESG," World Bank; J.P. Morgan, 2021.

PORTFOLIO CHOICES

Our analysis suggests that an investor choosing to invest in a region's equity or bond market will not face a total return or volatility penalty by incorporating ESG factors. However, when we think about constructing a portfolio there are two further considerations. The first is whether to allocate toward regions or indices within the public markets that have, on average, better scores. The second is how to incorporate private markets, for which ESG information tends to be less readily available.

Regional allocation

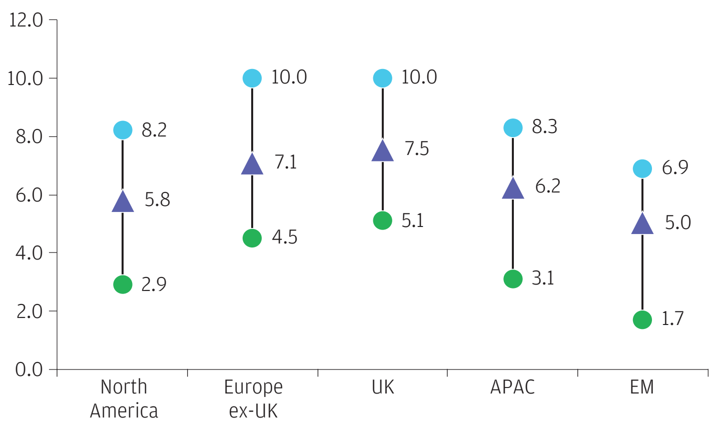
Investors looking to increase the ESG score of their portfolio might be tempted to avoid regions that have lower scores.

EXHIBIT 6 shows that – as one might expect – the aggregate scores are highest in Europe (7.1) and the UK (7.5) and lowest in emerging markets (5.0). ESG-conscious investors might be tempted to simply avoid emerging markets.

Scores vary within regions more than they do among regions

EXHIBIT 6: BENCHMARK ESG SCORES AND THEIR DISTRIBUTION BY REGION

Dots show the 10th and 90th percentile of the score distribution within each region. Triangles show the weighted-average score.



Source: MSCI, J.P. Morgan Asset Management; data as of June 30, 2021.

However, the exhibit also demonstrates that the distribution of scores within any region is much greater than the differences among regions. This means the security selection within a region is a much more powerful lever to improve a portfolio's ESG scores.

For example, removing emerging market equities from a global equity portfolio and reallocating to Europe and the UK, a shift of 11% of the equity portfolio, would increase the overall ESG score from 6.0 to just 6.1. By contrast, even a modest tilt to ESG leaders within each equity region would deliver a bigger boost to the overall equity score while maintaining the benefits of regional diversification.

Private markets

Investors might also be tempted to concentrate on markets where ESG scores are relatively easy to come by, which would focus a portfolio in listed markets (**EXHIBIT 7**).

ESG information is less available in private markets

EXHIBIT 7: SIZE OF DIFFERENT ASSET CLASSES VS. AVAILABILITY OF ESG SCORES

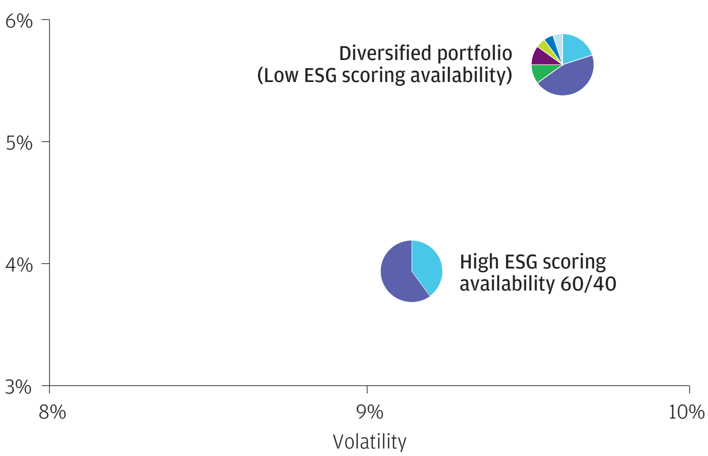
ASSET CLASS		SIZE, TRILLIONS, USD	ESG SCORE AVAILABILITY
GOVERNMENT BONDS	U.S.	21.8	Medium
	Europe	11.0	Medium
	Japan	10.8	Medium
	UK	2.7	Medium
	China	4.1	Medium
	RoW	9.2	Medium
PUBLIC CREDIT	Global investment grade	12.8	High
	Global high yield	3.3	High
PUBLIC EQUITY	U.S.	39.0	High
	Eurozone	5.6	High
	China	3.2	High
	Japan	3.9	High
	UK	2.4	High
	RoW	24.0	High
ALTERNATIVES	Private equity	4.7	Low
	Private debt	0.8	Low
	Real estate	10.3	Medium
	Hedge funds	3.8	Low
	Other real assets	1.0	Medium

Source: Bloomberg, HFR, Preqin, J.P. Morgan Asset Management Guide To Alternatives, J.P. Morgan Asset Management; estimates as of June 30, 2021. Public equity market cap data is taken from MSCI, and the data correspond to each region's headline index. This excludes companies not covered by MSCI, small cap companies, and a portion of the Chinese A-share market.

Yet private assets play an increasingly important role in generating income, diversification and alpha. The total asset universe is significantly reduced if investors focus solely on securities covered by major ESG rating agencies. **EXHIBIT 8** shows that a stylized portfolio that includes only widely scored assets would generate significantly lower returns (at only slightly lower risk) than a fully diversified portfolio.

Diversified portfolios that include "hard to score" assets deliver higher returns

EXHIBIT 8: FOCUSING ONLY ON "EASY TO SCORE" ASSETS REDUCES PORTFOLIO RETURNS



Source: J.P. Morgan Asset Management; data as of September 30, 2021.

Diversified portfolio
- U.S. aggregate bonds 20%
- U.S. large cap 45%
- Private equity 10%
- U.S. core real estate 10%
- U.S. value-added real estate 5%
- Global core infrastructure 5%
- Direct lending 5%

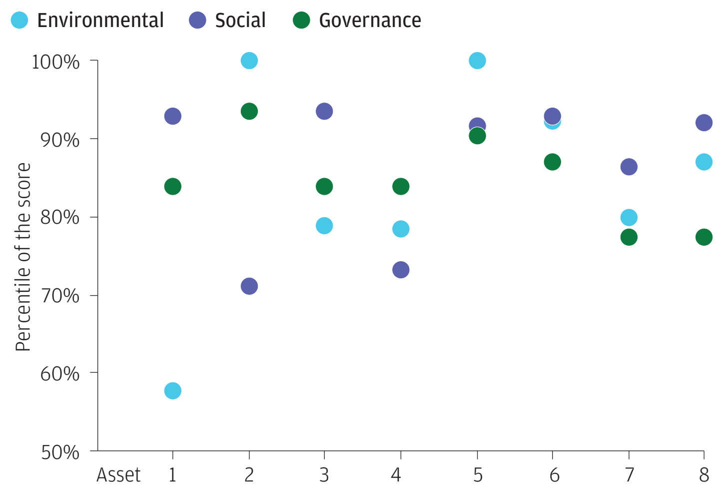
Equities and bonds only
- U.S. aggregate bonds 40%
- U.S. large cap 60%.

Private market assets are among the more difficult to score. But this does not mean that all private assets are the same in terms of their ESG profile. As **EXHIBIT 9** demonstrates, drawing on more specific, custom-made ESG assessments of a sample of infrastructure assets, private markets include assets with both weak and strong ESG credentials. Instead of excluding private market assets altogether – and thus paying some financial cost – ESG-conscious investors should make a sector and security selection within an asset class, whether it is in the public or private markets. This will also help drive sustainable outcomes, given the potential to actively engage with management teams in private markets (see **EXHIBIT 10** for some examples).

In sum, we recommend that investors select asset classes based on a desired risk-return outcome and then optimize for ESG characteristics within each asset class. Of course, within private markets this second step often requires considerable independent research.

Private markets include assets with both weak and strong ESG credentials

EXHIBIT 9: DISPERSION IN ESG RATINGS OF A REPRESENTATIVE SAMPLE OF INFRASTRUCTURE ASSETS



Source: GRESB, J.P. Morgan Asset Management; data as of June 30, 2021.

CONCLUSION

Incorporating ESG considerations does not come at a financial cost unless investors reduce their opportunity set to assets whose ESG characteristics are easy to score and for which scores are readily available. As we've discussed, investors will want to consider different approaches for different asset classes (for example, by focusing on material ESG risk when assessing bonds, while considering both risks and opportunities in the context of equities), while taking into account the important role played by rating agencies and scoring systems.

We see value in a two-step approach: choosing an optimal asset class mix based on traditional measures of risk and return, and tilting the portfolio toward ESG leaders or "improvers" within each asset class. We do acknowledge that finding those leaders can be challenging in private markets, but there are solutions. In many cases, this involves engaging with management and building a deep, fundamental understanding of risks and opportunities in key areas of E, S and G. Across public and private markets, investors need find no inherent tension between doing good and doing well.

Finally, given that ESG investing does not come at a cost in terms of performance, it can be seen as a "free option" to align portfolios with investors' values, as well as to prepare portfolios for the impacts of potentially tighter environmental or social regulation.

Different asset classes require different approaches to measuring ESG considerations

EXHIBIT 10: ILLUSTRATION OF METRICS TO MEASURE ESG IN PRIVATE MARKETS

	RELEVANCE OF ESG CONSIDERATIONS	POTENTIAL METRICS		
		Environmental	**Social**	**Governance**
PRIVATE EQUITY	As agents of change, sponsors are uniquely positioned to reform companies in ways that improve their ESG credentials. At the other end of the spectrum, we may see them pick up those assets that public markets are unwilling to fund – so-called brown-spinning.	Report on ESG outcomes of investee companies. Investee companies would be expected to report on metrics that are appropriate for their sector.		
PRIVATE CREDIT	As more investors seek to align their portfolios with sustainable outcomes, we are likely to see more managers begin to measure and report the ESG characteristics of companies they lend to.			
HEDGE FUNDS	Equity-oriented strategies with low turnover, and activism in particular, are well positioned to apply ESG principles. Short-term trend followers, however, may find it harder to formulate credible ESG strategies.			
INFRASTRUCTURE	Infrastructure has long been a focus of investors seeking to improve risk-adjusted returns by being mindful of environmental or social risks. In addition, infrastructure is attractive for those wishing to de-carbonize portfolios, given its ability to advance climate goals. The wall of capital that has recently entered the space is bidding up assets and may be a headwind for future returns.	• Carbon footprint • Physical climate risk assessments • International standards/bodies (e.g., GRESB)	• Human rights and community relations • Affordability • Health and safety	• Anti-corruption programs • Critical incident management
REAL ESTATE	Continually monitoring and improving the performance of properties in terms of energy use, social impact, water use and the amount of garbage waste can significantly improve the ESG credentials of real estate investments.	• Carbon footprint • Physical climate risk assessments • International standards/bodies (e.g., GRESB)	• Occupier satisfaction surveys and other measures of product quality • Labor practices	• Anti-corruption programs • Compliance-linked employee compensation
TRANSPORT	The transport industry is responsible for a significant share of air emissions. As customers start putting more weight on sustainable transportation, profitability and growth prospects may become inextricably linked to sustainable operations.	• Carbon footprint • Other emissions (e.g., NOx, SOx) • International standards/bodies (e.g., Poseidon Principles)	• Labor practices • Health and safety record	• Competitive behavior

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