

ESG and market inefficiency

The RBC Global Equity team

When the Global Equity team was formed back in 2006, we had two principles front of mind: i) that meeting our purpose of making a positive difference for clients would best be achieved through owning a portfolio of great businesses at attractive valuations and ii) that translating this into attractive returns would require robust portfolios that capture the value creation from the underlying businesses.

Our approach has always been to let the businesses in the portfolio drive returns. We consider that over the long term there is no other investment opportunity that adds value quite like the compounding power of a great business. This value creation ultimately should deliver positive absolute returns, but because great businesses are better than their peers, it should drive relative returns too.

Our view was that this was the best reward for the risk taken. To divert any part of the risk budget to other risk sources was thus going to compromise the return.

This was why the Global Equity team was created in this way, with a group of industry experts to identify great businesses by industry, and a risk and portfolio construction capability embedded within the team to ensure that the overall portfolio risk reflected our aims and purpose.

The challenge for active management

The way in which the team has executed its purpose, philosophy and process has enabled us to deliver a generally satisfactory set of outcomes to clients. But much of the rest of the industry has not been so fortunate; excess returns have been in decline and many asset owners have turned their backs on the active management of equities.

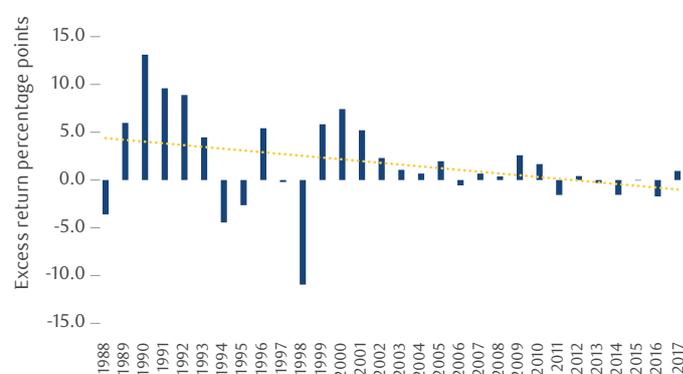
It is argued that if somebody's relative gain is somebody else's loss, once fees are deducted, the average manager is guaranteed to underperform. If one cannot identify a good manager, then it is better to go passive.

Industrialisation of sources of return

The shift to passive has been made easier by innovation. Exchange-traded funds (ETFs) now give investors cheap access to market returns and have made it easy to implement views of sectors, size or region. These are often referred to as 'factors' and represent shared characteristics of companies and/or stocks. Smart beta or quantitative strategies time such factors to derive an excess return.

Timing either the market or factors was traditionally a component of an active manager's return. But a computer via an ETF can now do this in a more robust way at a lower cost. Yet the decline in active excess returns is often cited as evidence that the market is increasingly efficient.

Excess returns versus MSCI World - NR (USD)



Source: U.S. mutual funds, Morningstar World Equity Large Cap 1988-2017.

The stock-picking opportunity

Has the stock-picking opportunity become exhausted? We don't believe it has.

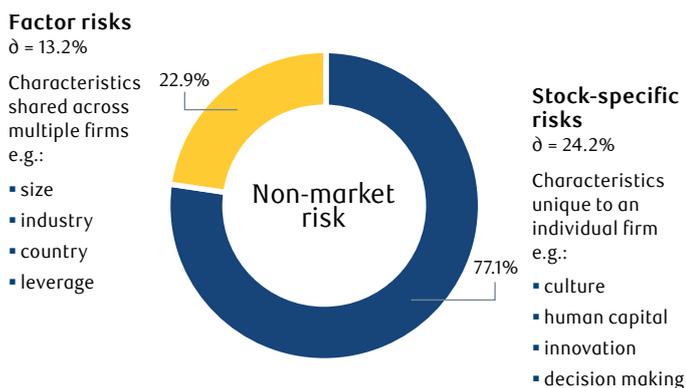
In the same way that factors describe shared investable characteristics, there are also elements that make a company unique and individual; things like culture, human capital, reputation and innovation. Our analysis indicates that such unique characteristics account for over three quarters of the movement of share prices around the market. That is significant opportunity for aware investors.

We accept that traditional financial analysis has become commoditised; the reward for diligently analysing financial data has been eroded. Databases and computers today replicate in moments the work that once took analysts weeks.

But a computer can only analyse the data it is given; it cannot see what is not in the financials. This is where we believe intangibles such as ESG can make an important difference. Many of the unique company-specific characteristics, like culture and human capital, are

ignored by traditional financial reporting but can in time become material and impact the financial statements, positively or negatively. These are ‘pre-financial’ factors or leading indicators of future financial performance. By integrating ESG into company analysis, the investor can get a more complete view of such data and hence make better decisions. This puts ESG at the centre of the market inefficiency that can be exploited by active managers.

Attribution of non-market returns between stock-specific sources and factors



Source: MSCI World Index, 31.12.2016

Conditions for success

ESG issues can take time to become apparent so accessing such insights requires investors to have a long-term ownership mind-set. A short-term trader is unlikely to be present when such things become material, but owners of long-term capital are ideally suited to benefit from this market inefficiency.

ESG data is often qualitative, contextual and not always available in a simple quantitative form and therefore the investor will need to ask different questions in order to uncover this pre-financial information. We consider this to be done most effectively on a case-by-case basis by the risk-taker rather than applied either in a top-down way or by a separate group of ESG analysts. A more complete understanding of the full risks and opportunities builds conviction, allowing the risk-taker to construct portfolios with a limited number of names and extended holding periods.

Academic studies over the last several years have found that focused portfolios, with high active share and extended holding periods, have tended to outperform. These studies have also shown that diversified portfolios with a high active share have also delivered better risk-adjusted returns than their peers.^{1,2}

In our opinion, this speaks to the type of return that investors are accessing when they focus on the specific

company. Sources of return from characteristics like human capital, culture and reputation are specific to particular companies. They are unique; they are independent of others. Interestingly, this then offers investors potential to diversify sources of return. If they can execute correctly, get a better return for the same risk – or lower risk for the same return – the result is a more efficient portfolio.

It would be naive to assume that a simple collection of company-specific investment theses will result in a balanced portfolio. If too many of those investment ideas share similar characteristics, the investor may unwittingly create unintended biases in the portfolio that have nothing to do with the investment philosophy; it is the portfolio construction equivalent of putting too many eggs in one basket. For example, an American personal products company, an Australian iron-ore miner and a European car maker do not share common industries or countries of incorporation, but they may be connected because they are sensitive to Chinese consumption. The outcome of such an unintended bias might be positive or negative but it would be impossible to predict as such risks have nothing to do with investing in great businesses and their outcome cannot be predicted. But they will add volatility.

We consider that volatility with no positive expected return is a poor use of risk and best avoided. As such, intelligent portfolio construction is essential. It is about striking a balance between investing in all the highest conviction investment opportunities that are available and also adjusting position sizes to control unintended concentrations and factor exposures. The result should be, in our opinion, the best expression of the integrated ESG/company-specific approach so that portfolio returns are driven by the underlying businesses and not factors.

Active ownership

This is of increasing importance to many asset owners who care not just what the return is, but also how it is generated. Stewardship is considered an important non-financial part of the return stream and we also think it is a way in which an investor can do well by behaving responsibly.

As asset managers we have a responsibility to the companies we own on our clients' behalf. By encouraging these businesses to act responsibly and to embrace issues of sustainability, we like to think that we are helping to make them better businesses. We are thereby making an impact, and that is good for our clients as we believe better businesses will deliver better results over time. But the businesses also employ people who have families and who live in communities. By supporting better businesses, therefore, we hope to make a positive difference to society as a whole.

Conclusion

When we started out in 2006, ESG and ETF were not widely

understood acronyms, yet they have gone on to have a significant influence upon the industry. Indeed, we have probably yet to see their full potential. In addition, we think active ownership is only likely to grow in importance as more investors appreciate the responsibility they have, not only to their shareholders but also to the companies they own. In our view ESG is a source of market inefficiency that, when combined with active ownership,

allows asset owners to achieve better outcomes for shareholders, for the companies they own and for society as a whole. That is an investment return we can be proud of.

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Jeremy is a Senior Portfolio Manager and is the Consumer Specialist on the Global Equity team. Jeremy joined RBC Global Asset Management with the team in early 2014 after having spent more than seven years with them at First State in the same capacity. Previous experience includes roles at Credit Suisse Asset Management and Schroders Investment Management.

Jeremy holds a BA (Hons) in Economics from the University of Exeter. He is also a qualified accountant, having trained at Price Waterhouse in London.



Sources:¹ "Patient Capital Outperformance" by Martijn Cremers and Ankur Pareek, December 2013. ²"Active Share and Mutual Fund Performance" by Antti Petajisto, January 2013.

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