Insights
Environmental, Social & Governance (ESG)

March 2021

ESG, Tracking Error and Long-Term Performance

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The market is replete with studies that research the relationship of ESG integration and performance. Tracking error is often discussed in conjunction with performance and the issue of tracking error against a strategic benchmark arises in most client conversations around ESG integration.

In our 2021 ESG outlook, we highlighted that investors tracking an underlying benchmark often have strict limits on tracking error embedded in their investment processes. Yet, deviations from standard benchmarks become inevitable when ESG considerations are included in index methodologies. Also, with rising ESG adoption and the notion of ESG becoming "**The New Normal**" it is not inconceivable that ESG considerations will make their way into standard benchmarks.

So how should investors evaluate tracking error in light of internal and external pressure for more ESG integration?

Revisiting Tracking Error and Performance

Let's revisit the concept of tracking error.

- Tracking error shows the divergence between the price of a portfolio and its benchmark.
- It is symmetric.
- Tracking error only provides an indication of overall divergence; it doesn't show the direction of this divergence.

In light of ESG integration, a portfolio with high tracking error can still deliver long-term cumulative returns broadly similar to the benchmark, assuming that the direction of returns deviations is non-biased.

Below is an overview of the performance and tracking error of a subset of available global ESG indices. It's important to note that these indices are constructed using different ESG data and construction methodologies:

Figure 1
Return and Tracking Error (TE) of Select ESG Indices*

Index	Annulised Return (%)			
	1 Year	3 Years	5 Years	TE
FTSE4 Good Developed Index	29.41	11.61	14.96	1.49
FTSE Developed Index	30.37	11.17	14.76	—
MSCI World ESG Leaders Index	28.07	11.98	14.58	1.17
MSCI World Index	29.98	11.37	14.73	—
S&P Global 1200 ESG Index	29.19	11.81	15.21	1.82
S&P Global 1200 Index	29.24	11.05	14.82	—

*Date as of 26 February 2021.
Source: FTSE, MSCI, S&P and State Street Global Advisors.

As the figures show, over the long run, while tracking error can be quite significant, overall performance for these ESG indices doesn't suffer.

Additionally, a recent meta-study found that not only do ESG investments generally exhibit robust performance and provide downside protection, especially during a social or economic crises but, more importantly in this context, that improved financial performance due to ESG becomes more noticeable over longer time horizons.[1]

Therefore, when evaluating performance and tracking error, it is important to be very conscious about the time horizon in question. In the ESG space, time horizon considerations have been, and often still are, challenging, due to the lack of reliable ESG data with long histories. However, an increasing volume of ESG data is continually being generated, so this will become less and less of an issue.

Having said this, investors should fully understand the exact methodology and details of their ESG approach: is it exclusion only, best-in-class (optimised or rules-based), a thematic (e.g. climate) approach, or a combination of these? In addition, what are the implications of the respective methodologies for the re-allocation of securities? This helps investors understand likely interim performance variations and can help them manage expectations and be better prepared to explain short-term performance patterns.

In this context, these high-level findings don't provide a detailed description of the impact of the ESG integration on performance. To shed light on this question, separate research involving a detailed attribution analysis is needed which is beyond the scope of this piece.[2]

The Concept of a Reference Portfolio and its Connection to ESG

The Reference Portfolio has been defined as that "which is capable of meeting the Fund's objectives over time, and is a shadow or notional portfolio of passive, low-cost, listed investments suited to the Fund's long-term investment horizon and risk profile".[3]

The reference portfolio acts as a theoretical overall benchmark and is often described as an "equilibrium" concept, as it is structured based on an investor's assumptions of the average long-term returns of various asset classes, regardless of what is actually happening to those returns in short-term market conditions.

Given the evidence that ESG integration in passive vehicles does not detract fromlong-term performance, ESG considerations are perfectly suitable to be integrated into the concept of a Reference Portfolio, thus changing the perception of what a "standard benchmark" should look like.

Alongside this shift, we will likely see a re-evaluation of the appropriateness of typical benchmarks to investors' individual circumstances. This should lead to an increase in demand for customised benchmarks and standard benchmarks becoming more ESG aware.

Tracking Error Against What?

With investors increasingly adopting ESG-aware benchmarks, the question arises: which tracking error is most "relevant"— tracking error against the traditional benchmark or the ESG version of the benchmark?

This is a tricky question particularly when managers are asked to manage proprietary investment solutions against an ESG index that might use completely different ESG data sources in the index construction methodology than the proprietary model of the respective manager.[4] It becomes a matter of comparing apples to oranges and could also make the conversation around tracking error flawed.

Looking Ahead

Given ESG is becoming mainstream, asset owners will likely need to rethink how to choose tracking error budgets against their standard policy benchmarks.

As ESG considerations often differ between investors, the implications of adding an ESG dimension for investment processes will lead to differing views as to what is considered a low or high tracking error.

Additionally, as investors increasingly become aware that incorporating ESG is not detrimental to value in the long run, tracking error attributable to ESG integration vs. traditional benchmarks will become less of a concern, which should favour increased ESG adoption.

Endnotes

1 https://stern.nyu.edu/experience-stern/about/departments-centers-initiatives/centers-of-research/center-sustainable-business/research/research-initiatives/esg-and-financial-performance.

2 We are writing a separate paper on this topic.

3 Definition from New Zealand's Sovereign Wealth Fund: https://portfolio-institutional.co.uk/features/reference-portfolios-the-good-the-bad-and-the-ugly/.

4 Third-party ESG index providers employ different ESG methodologies and utilise ESG data that display low correlations between providers.

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ID430093-3497962.1.1.GBL.RTL 0321
Exp. Date: 31/03/2022