EMPIRICAL
ASSET MANAGEMENT

SPECIAL COMMENTARY

ESG is a Universe not an Investment Methodology

In the beginning (the 1970's) you had to be a hippie to invest in ESG. They called it SRI back then, Socially Responsible Investing.
The hint that it would not work in that form was in the I - Investing. The E, S and G signals generally do not help you gain return. You need to find that elsewhere, as we do. They can, however, help you control risk.

The Early Days

The initial pitch was that investing in companies that did socially responsible things would provide better performance over time. The sad truth is that Wall Street (WS) and Main Street crushed that idea. Nobody cared. They traded their souls for profit. Let's say that another way, Capitalism was more powerful than democracy. It almost always is. After a couple of decades of foundation work, in the 80's and 90's I literally watched people I knew wager their entire careers that SRI was ready to catch on. Sadly, they were wrong. They even tried to change their marketing messages into, "you will be investing in companies that do good by the world, but your performance will suffer." There still were not enough investors who cared.

Equal Rights for Woman, Disparity of Wealth and Global Warming

After inventing the internet, Al Gore found time to give us a bigger cause to care about. Who wouldn't care about the earth and the very survival of human existence?
The disparity of wealth being at an historic high prompts social unrest everywhere, including in the Boardroom and on WS. As for woman's rights and the size of that potential audience, last time I checked, women are slightly more than half of the world's population and many men are married to women. WS may not be the sharpest knife in the drawer but will eventually get it when money is involved. Essentially WS is a giant voting machine that figures out where you can make the most money. Also, WS is much better at marketing than it is at investing. Eventually WS figured out that because so many people cared about the issues, ESG understood that there was a ginormous audience for them to market their ESG products.

Fast Forward to Today

Like the opening of the Big Bang Theory, where they run through human existence in 30 seconds or so – SRI, Global Warming, Women's Rights, Apartheid, Ethics field, Big Data, Computing Power, Rating Companies, Marketing Power, Harvard-Yale Football game, Larry Fink, lead us to the Big Bang - $Trillions in ESG funds.

Performance Still Matters – It Always Does

The world still cares about performance first and foremost. A year ago, I showed our strategy to a 55-year-old prospect. I pitched it as an ESG portfolio. After hearing me out he said, "I'm not really into ESG. I just want companies that make me money." When I inquired further asked him to consider our excellent performance he said, "I am too old to change the world, I prefer return and I don't really think ESG can get me better performance." He said he would leave the changing of the world part to the millennials. I tried to pivot and explained that our strategy easily outperformed the S&P 500 over the last 6 years, and he responded, "I just don't want ESG." I had lost him at ESG. That was eye opening.

Can You Have Your Cake and Eat it Too?

According to S&P Dow Jones Indices LLC, 85.6% of Large Cap funds were outperformed by their Benchmark, the S&P 500, over the last 10 years ending 3/31/2020, 79.0% in the last 5 years. Add an ESG mandate and you do the math, very few outperform. It is difficult enough to outperform, why make the challenge that much harder by relying on the ESG signals to be rewarded by investors. At Empirical we believe that WS has not figured out where ESG fits into the investment process properly. Here is our take. When building any portfolio, one should follow these three steps:

1. Define your universe
2. Identify your benchmark
3. Apply your methodology to get better performance than the benchmark.

We believe WS has generally inserted the ESG in the wrong place, Step 3, in an attempt to use that signaling to gain a performance benefit. While it is true that with the gigantic flow of assets into ESG strategies a performance bump has and will continue to be a benefit, that benefit will wane over time as highly rated ESG companies will become more expensive. The true benefit is in the controlling of risk (mainly headline risk and credit risk) which we believe should be a residual effect not the focused effect. To learn how Empirical inserts the ESG signaling in a different Step and utilizes our proprietary *AlphaSourcing*® and Higher Moment Optimization processes to drive Alpha generating returns that have handsomely outperformed the S&P 500, please visit our website, www.empiricalam.com, or call us at 781-431-2220 anticipated in any such forward-looking statements. Information contained herein is as of the period indicated and is subject to change. Any views expressed herein are those of the author(s) at the time of writing and are subject to change without notice. The information contained herein includes information obtained from sources believed to be reliable, but we do not warrant or guarantee the timeliness or accuracy of the information as it has not been independently verified. It is made available on an "as is" basis without warranty.

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Sources: Bloomberg.

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