

Q1 2022 IS “ESG” CROWDED? A FIRST LOOK

In this Research Spotlight, we aim to investigate a question that is frequently raised by investors: *Is “ESG” crowded?*

The question of position crowding is important for several reasons, most crucially as it pertains to risk management discipline and the future outlook for ESG investment returns. In the discussion to follow, we highlight our approach to monitoring and assessing crowding risk in ESG, and review some of our ongoing research in this area.

Before any analytical assessment of “ESG crowding” can be conducted, it is important to clarify definitions. What do we mean by “ESG” in this instance, and what do we mean by “crowding”? This is not simply a matter of semantics, as definitions are crucial when assessing data and the implications of any analysis. And while it may seem trivial, in fact defining both “ESG” and “crowding” are more nuanced challenges than a simple question suggests.

So, what do we mean by “ESG” in this discussion?

As we discuss with investors regularly, ESG can mean quite different things to different people. We know that many equity funds and strategies currently marketed or described as “ESG” or “sustainable”² apply some element of exclusionary screening (no tobacco, no thermal coal investments etc.) but otherwise follow a standard investment style or practice. If the majority of ESG investment flows were in such exclusionary approaches, one might hypothesise that the biggest impact might not be “crowded” *long* ESG positions, but rather structural underinvestment or depressed valuations in common names or subsectors subject to such exclusionary screening. Other investment strategies primarily focus on “ESG integration” rather than exclusions (though exclusions are a common part of such strategies as well), with the long-only community owning “good ESG” companies in their strategies.³ A reasonable hypothesis could be that excessive flows or demand for ESG integration strategies in long-only investing may lead to crowded positions or valuation distortions in certain sectors or particular names that are widely held across a large number of ESG strategies or funds. Finally, one can consider ESG investing from the perspective of thematic investing, where investors are considering investments primarily through the lens of *double materiality*, rather than a focus on companies that excel at managing their E, S and G risks. Thematic ESG investing puts a focus on external societal impact – typically, investing in companies that are focused on some sort of “solution” to a society wide ESG challenge.

While common and popular forms of thematic ESG investing are often focused on the “E” – think clean

energy and renewables funds or ETFs – there has also been increasing interest in S pillar thematic funds, for example addressing issues of diversity, or attempting to align investments with the UN SDGs. Together, these three investment approaches (which are not mutually exclusive but provide a useful categorisation) capture the majority of ESG investing with respect to active and passive equity funds and ETFs. So, to answer the question posed above, for the purposes of our discussion here it is the combination of investments in these types of equity strategies that we mean when we talk about “ESG”.

There is no doubt that all three flavours of ESG investing described above have become increasingly popular in recent years, with a rapid acceleration in interest and flows beginning in 2018.⁴ However, understanding the interplay and cumulative net impact of all investment flows on the market, security valuations and potential future returns is challenging, and we note there are a number of potential techniques to try and assess a degree of “crowding risk”.

What do we mean by “crowding”? In principle, investor crowding in an asset or sector suggests that excessive enthusiasm and inflows (or lack of enthusiasm or outflows) creates an adverse situation in terms of forward-looking risk / return for the investments (or a favourable environment for under-owned names or “popular shorts”). This risk could be assessed from a market technical standpoint, looking at price related metrics such as RSI, Bollinger bands, or other tools of technical analysis, in order to determine short term “overbought” or “oversold” conditions. Similarly, one could evaluate differentials in common equity valuation metrics (such as P/E ratio) on an absolute or relative basis, to try and determine if net flows have created valuation distortions that would suggest adverse risk/reward for future returns. In our analysis below, we focus on a valuations-based assessment of crowding, rather than a technical approach.

Our Framework for Evaluating ESG Crowding

For the purposes of our analysis, we wish to assess the net impact of aggregate active and passive “ESG flows” across an investable equity universe, and so look to determine if:

1. A valuation premium (or discount) is evident across the universe, and more specifically, at the sector level, and
2. For evidence of an increasing (or decreasing) valuation premium (or discount) after 2018, when ESG investment flows accelerated rapidly.

Given the different growth prospects for “high ESG” vs. “low ESG” companies, it is not unreasonable to posit there may be a valuation premium of some sort for “high ESG” companies that is unrelated to the impact of investment flows, if these names can be expected to have better long-term growth prospects, for example (note: this is a hypothesis). Looking at valuations before and after 2018, and the evolution through time, should help provide some insight into whether or not the more recent regime of interest in ESG and increase in ESG fund flows has changed the average valuation profile across “high ESG” and “low ESG” names – i.e., if there is a “crowding effect” that is evident from shifts in valuations between cohorts of stocks based on ESG considerations.

To conduct our analysis, we need to define 1) our evaluation universe of securities, 2) a specific criteria for “high ESG” and “low ESG” names, and 3) relevant valuation metrics.

For the evaluation universe, we utilise our “investable” global equity universe, which we use for our fund’s portfolio construction, and which forms the initial stage of our investment process for the ECO Advisors ESG Absolute Return strategy. We note that our investable universe only includes securities where relevant ESG data is available, and excludes small cap and less liquid securities, and is therefore somewhat less broad than the ACWI IMI. As such, it may not be fully representative for all types of investors. However, we believe it provides a sufficiently diverse set of liquid and investable equities across both developed and many emerging markets, and hence a solid foundation for our crowding analysis. While the universe size varies historically (and has grown through time), the current size of the universe we analyse is around 5,000 securities globally.

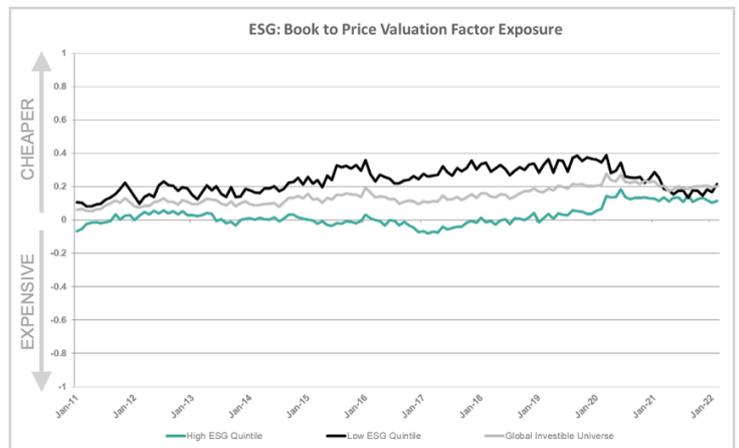
For our ESG criteria, we utilise MSCI ESG Ratings and scores to examine high and low fractile cohorts of names that rank highly or poorly on MSCI ESG criteria. As one of the largest and most widely adopted sources of ESG data for institutional investors, we feel utilising MSCI’s IVA score is a useful proxy to identify “high ESG” and “low ESG” securities with respect to an analysis of ESG crowding, from the perspective of the impact of fund flows, as these data will likely be integrated in some fashion in a significant portion of institutional active ESG strategies.

Furthermore, MSCI’s ESG criteria has significance for crowding analysis as the one of the dominant data providers for passive ESG funds and ETFs with the largest market share – which may be more likely to produce a “crowding” effect than actively managed funds. According to research from Goldman Sachs, “roughly 35% of ESG ETFs and 59% of all related AUM today employs MSCI ESG scoring in security selection, including eight of the ten largest funds globally.”⁶ Of course, different ESG data sources and methodology in assessing ESG may come to different conclusions, but in the absence of a generally accepted standard for

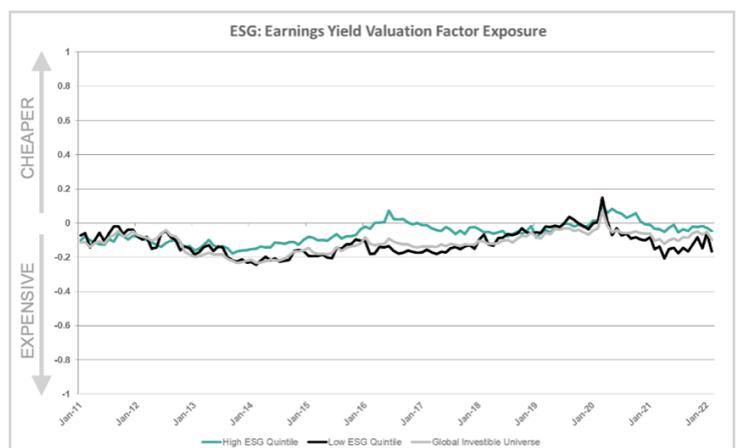
ESG, evaluating through the lens of MSCI ESG seems to us a reasonable starting point for an evaluation of ESG crowding in the market, particularly in light of the market penetration for ESG passive funds using MSCI ESG criteria.

In our analysis, we focus on evaluation of top and bottom quintiles of securities ranked by MSCI ESG IVA score, which forms the basis for MSCI ESG ratings.⁷ For our equity valuation metrics, we utilise the Barra Global Equity model, and evaluate the average (equally weighted) factor exposures of our high and low ESG fractile portfolios to valuation factors in the model. We focus our analysis on two key valuation factors in the model for equities, Book to Price (BTOP) and Earnings Yield. The Book to Price factor is straightforward to interpret as a valuation measure; we note in interpreting the charts to follow that a *higher* BTOP score (positive factor loading) represents a more attractive (*cheaper*) Book to Price valuation.

The Earnings Yield factor is built from a number of descriptors (factor building blocks) and is a composite of Enterprise Multiple (EBIT to EV), Cash Earnings-to-Price, Earnings-to-Price and Analyst-Predicted Earnings-to-Price.⁸ Similarly to the interpretation of BTOP, a *higher* Earnings Yield exposure indicates a “*cheaper*” stock. Finally, exposures are normalised Z-scores based on the overall equity estimation universe for the model; an exposure of 1 can be interpreted as higher than roughly two-thirds of the overall equity model estimation universe.



Y axis shows average valuation factor exposure. Higher = cheaper valuations, lower = expensive valuations. ESG quintiles based on MSCI ESG IVA Scores. Source, ECO Advisors, MSCI



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ESG Crowding in the Broad Universe

We aim to see if the average “high ESG” exposure to valuation factors has been materially different to the “low ESG” exposure, and if there are any signs that this relationship has shifted before and after 2018, when ESG investment flows became significant. Is there evidence suggesting that a portfolio built from “high ESG” names may be structurally overvalued due to crowding? Or that the increase in ESG fund flows may have shifted historical valuations materially in recent years between “high ESG” and “low ESG” quintiles?

Examining the time series of Book to Price and Earnings Yield since 2012, we see little evidence for a crowding effect becoming evident as ESG has increased in popularity and flows. We do find evidence of a structural and persistent historical Book to Price discount for the “low ESG” quintile, but – in contrast to what would be expected from ESG crowding – this discount has been declining, not increasing, during the last two years. We hypothesise this may be a result of the post-Covid cyclical economic and markets recovery, where we have seen some “low ESG” and particularly more carbon intensive companies in cyclically sensitive sectors (such as Energy and Industrials) undergo a re-rating.⁹

When reviewing Earnings Yield, we find at the universe level very similar average exposures to the Earnings Yield factor, and in fact a small valuation discount for “high ESG” companies, though the magnitude is modest and unlikely to be material. And similar to the trend in Book to Price factor, our “low ESG” quintile has become modestly more expensive over the last two years. Taken together, we see little evidence in these data for ESG crowding, at the investable universe level. However, there may be crowding effects that are concentrated in certain sectors or industries. In particular, we note the rise of thematic investing during the recent period of ESG popularity and inflows; is “ESG crowding” evident at the Sector level, even if there is little evidence when reviewing high and low ESG securities across a broad investable universe of high and low ESG securities? To answer this question, we extend our analysis to each of the GICS Level 1 sectors in a similar fashion.

Our results are summarised in the below table which continues on to the following page. To understand the table:

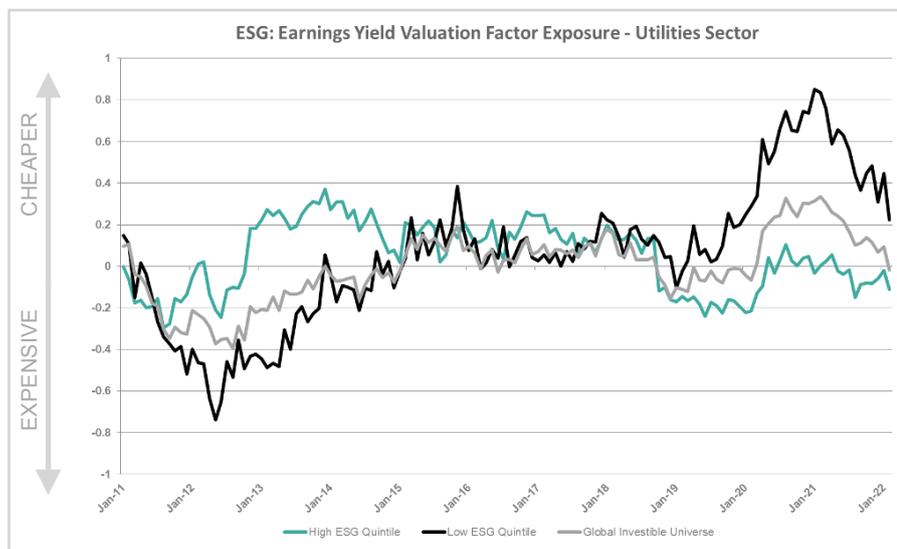
➔ Positive exposures indicate "cheaper" or more attractive valuations, and are averages of quintile factor loadings (Z-scores)	➔ A more positive value for Difference indicates "ESG cheapness", whilst a negative spread suggests ESG is more expensive	➔ A trend in Difference through time that becomes more negative (High - Low exposure moves from positive to negative) suggests a potential crowding effect
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Factor Exposure Summary	Quintile Analysis	Book to Price			Earnings Yield			Comments
		Average Exposure	High ESG	Low ESG	Difference	High ESG	Low ESG	
Investible Universe	2012-current	0.03	0.25	-0.22	-0.06	-0.12	0.07	No evidence for ESG crowding
	2012-2017	0	0.23	-0.23	-0.08	-0.16	0.08	
	2018-today	0.07	0.28	-0.21	-0.02	-0.07	0.05	
	Current (Feb 2022)	0.11	0.21	-0.10	-0.05	-0.17	0.12	
Consumer Staples	2012-current	-0.31	-0.30	-0.01	-0.24	-0.41	0.18	No evidence for ESG premium or crowding
	2012-2017	-0.37	-0.31	-0.06	-0.30	-0.45	0.15	
	2018-today	-0.23	-0.29	0.07	-0.15	-0.36	0.21	
	Current (Feb 2022)	-0.17	-0.20	0.03	-0.10	-0.14	0.04	
Consumer Disc	2012-current	-0.23	0.09	-0.33	-0.08	0.02	-0.10	Some evidence for ESG BTOP premium; little evidence of crowding
	2012-2017	-0.27	-0.01	-0.26	-0.10	0.01	-0.11	
	2018-today	-0.17	0.25	-0.42	-0.05	0.02	-0.07	
	Current (Feb 2022)	-0.12	0.19	-0.31	-0.12	-0.13	0.01	
Utilities	2012-current	0.09	0.56	-0.47	0.07	0.08	-0.01	Evidence for ESG valuation premium and potential crowding effects
	2012-2017	0.16	0.45	-0.29	0.14	-0.10	0.24	
	2018-today	0.00	0.72	-0.72	-0.05	0.34	-0.38	
	Current (Feb 2022)	0.05	0.90	-0.85	-0.11	0.22	-0.33	
Materials	2012-current	0.26	0.32	-0.07	0.02	0.00	0.02	No evidence for ESG premium or crowding
	2012-2017	0.25	0.38	-0.13	-0.09	-0.20	0.11	
	2018-today	0.27	0.25	0.02	0.17	0.28	-0.11	
	Current (Feb 2022)	0.27	0.08	0.20	0.29	0.34	-0.05	
Industrials	2012-current	-0.12	0.14	-0.25	-0.05	-0.03	-0.02	Evidence for historical ESG BTOP premium; no evidence of crowding
	2012-2017	-0.12	0.08	-0.2	-0.06	-0.08	0.01	
	2018-today	-0.1	0.22	-0.33	-0.03	0.03	-0.06	
	Current (Feb 2022)	-0.07	0.08	-0.15	-0.07	-0.18	0.11	
Energy	2012-current	0.57	0.84	-0.27	-0.31	-0.25	-0.06	See next page
	2012-2017	0.49	0.68	-0.19	-0.37	-0.4	0.03	

Factor Exposure Summary	Quintile Analysis	Book to Price			Earnings Yield			Comments
		High ESG	Low ESG	Difference	High ESG	Low ESG	Difference	
	Average Exposure							
Energy (cont.)	2018-today	0.68	1.06	-0.38	-0.22	-0.02	-0.21	Evidence for historical ESG BTOP premium and crowding; however, recent convergence in valuations
	Current (Feb 2022)	0.48	0.52	-0.04	0.07	-0.01	0.08	
Healthcare	2012-current	-0.34	-0.31	-0.03	-0.5	-0.84	0.35	No evidence for ESG crowding. Crowding in low ESG innovation/biotechs?
	2012-2017	-0.38	-0.27	-0.11	-0.54	-0.7	0.16	
	2018-today	-0.29	-0.36	0.07	-0.43	-1.05	0.62	
	Current (Feb 2022)	-0.25	-0.27	0.02	-0.55	-1.17	0.62	
Financials	2012-current	0.55	0.78	-0.23	0.28	0.29	-0.01	
	2012-2017	0.45	0.68	-0.23	0.18	0.15	0.02	
	2018-today	0.7	0.93	-0.23	0.43	0.5	-0.06	
	Current (Feb 2022)	0.87	0.97	-0.1	0.4	0.36	0.04	
IT	2012-current	-0.18	-0.23	0.05	-0.08	-0.28	0.19	No evidence for ESG premium or crowding
	2012-2017	-0.15	-0.21	0.06	-0.05	-0.27	0.23	
	2018-today	-0.22	-0.27	0.04	-0.14	-0.28	0.14	
	Current (Feb 2022)	-0.22	-0.29	0.06	-0.2	-0.34	0.14	
Telco **	2012- Nov 2017	-0.24	0.00	-0.24	0.04	-0.36	0.41	
	Nov 2017	-0.36	0.42	-0.78	0.00	-0.14	0.14	
Comm Services **	Dec 2017 to Feb 2022	-0.12	0.07	-0.19	0.01	-0.37	0.37	No evidence for ESG crowding
	Current (Feb 2022)	0.00	-0.11	0.11	-0.05	-0.51	0.46	

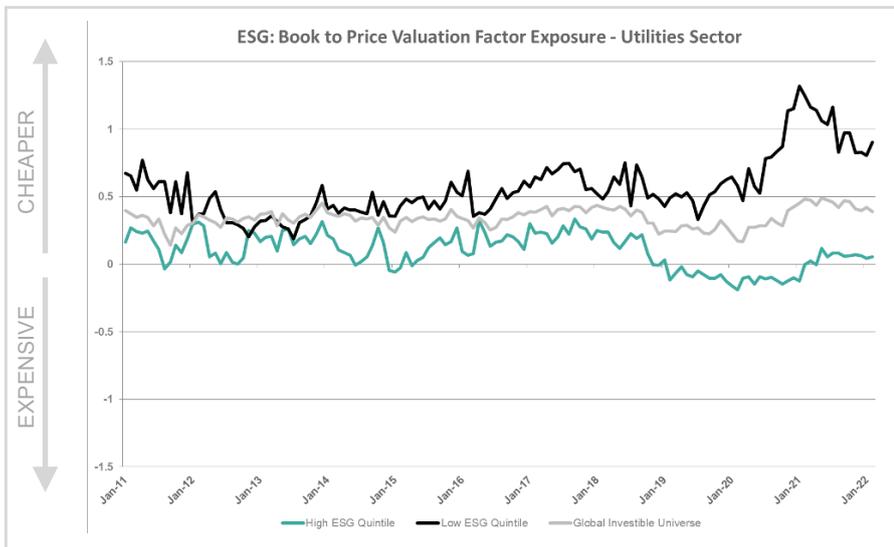
We find a similar story across most sectors that we see at the investable ESG universe level: there appears to be little evidence for shifts in valuations across high and low ESG quintiles that would suggest investor crowding. However, there is certainly evidence in certain sectors – in particular, Utilities and Energy – that an ESG crowding effect has been likely.¹⁰

In the Utilities sector, we find historically (pre-2018) a Book to Price discount for “low ESG” Utilities, and similar Earnings Yield exposures. However, a significant valuation spread forms from 2018-2020, peaking in early 2021, and converging over the last 12 months. While the valuation gap has reduced significantly from its peak in early 2021, it remains wider than long term historical averages. It is reasonable to hypothesise investors have increasingly required a significant valuation discount to hold “low ESG” utilities, which became extreme in late 2020 / early 2021. Given the growing regulatory risks, increasing costs for carbon emissions over time (see prior Research Spotlights for a discussion of global ETS developments), and long term growth prospects for “greener” providers, some valuation premium for “high ESG” names in the sector is not surprising. The size of the valuation spread, however, does suggest ESG crowding may have been a factor in driving valuations.

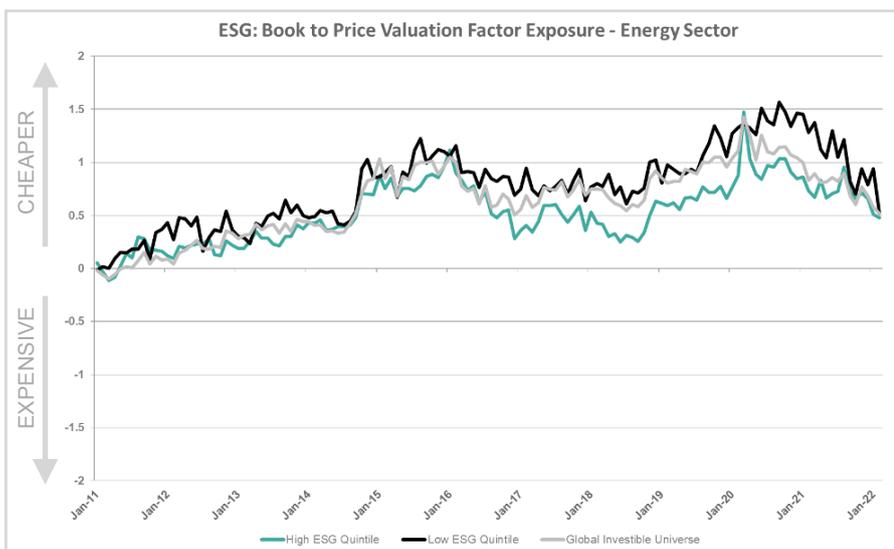


Y axis shows average valuation factor exposure. Higher = cheaper valuations, lower = expensive valuations. ESG quintiles based on MSCI ESG IVA Scores. Source, ECO Advisors, MSCI.

In the Energy sector, we see a Book to Price valuation premium emerge after the 2015 Paris Agreement, and a similar Earnings Yield premium emerge for “high ESG” energy companies. Similar to the Utilities sector, we observe a decline in the “high ESG” valuation premium occurring over the last 12 months, to such an extent that as at February the valuation spread has converged. In conclusion, our analysis suggests an observable ESG premium and potential evidence for historical crowding effects in these two “E” focused sectors, which appear to have peaked in Q1 2021. We are not entirely surprised by this result; anecdotal evidence for “excessive” retail enthusiasm for clean energy in 2019 and 2020, and the excitement around the Democratic “Green Deal” were widely discussed by investors and market practitioners at the time.



Y axis shows average valuation factor exposure. Higher = cheaper valuations, lower = expensive valuations. ESG quintiles based on MSCI ESG IVA Scores. Source, ECO Advisors, MSCI. Note



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Importantly (for our investment process and outlook), we find little evidence of “ESG crowding” in other sectors or at the broader universe level, as well as a significant contraction in the valuation premium in the Energy and also to some extent in the Utilities sectors in the past few quarters. Given the long term outlook and prospects, some valuation premium for “high ESG” in these “E focused” sectors is not unexpected.

Our work suggests a more constructive outlook for ESG-focused investments in these two sectors than we had one year ago, and little reason to fear a more general “ESG crowding” across a broader range of sectors. Furthermore, the results indicate that while the “E theme” may have become crowded in 2019 and 2020, the broader universe of “high ESG” has not exhibited convincing evidence of crowding effects.

REFERENCE FOOTNOTES

1. As at 31st March, no company in the long book has material business exposure to Russia (according to analysis of the portfolio using data from Bloomberg).
2. The question of “ESG integration” and “sustainability” definition is also challenging and non-trivial, but beyond the scope of this Spotlight.
3. Of course, there are many forms of ESG integration, and recently more emphasis has been placed on either companies that are improving on their ESG credentials, or in more extreme cases an activist approach, which focuses on investment in poor ESG performers and agitates for ESG improvement at the corporate level. While these approaches to integration complicate any analysis, the most common form of ESG integration remains focusing long holdings on companies with a favourable ESG profile.
4. This assertion is supported by flows analysis from our Prime Brokers, as well as sources such as Morningstar. See, for example <https://www.morningstar.co.uk/uk/news/216474/sustainable-assets-are-teetering-on-the-%244-trillion-mark.aspx> for an illustration of the substantial increase in flows from 2018 through 2021.
5. According to data from MSCI as of September 2021.
6. Goldman Sachs research, “Exclusions in ETFs: A Sign of Things to Come?”, Jan 2021
7. As part of our research, we have also evaluated groups of securities by MSCI ESG rating (AAA and AA, CCC and B) as an alternative to fractiles. We find a fractile approach more robust in ensuring a similar number of names in each cohort to form a representative average, whereas the number of securities in each ratings bucket can vary over time. For this reason, we prefer the fractile approach; we note our broad conclusions remain robust to choice of grouping methodology in any event.
8. N.B. We have also looked directly at the factor descriptors as part of our analysis; our broad conclusions on crowding remain unchanged. We focus on BTOP and Earnings Yield factors in this discussion for tractability.
9. See our discussion in prior Research Spotlights on performance of Carbon Intensity as a factor, for a more detailed discussion.
10. Of course, we are not the first or only firm to highlight evidence for crowding related to the clean energy thematic. See, for example, <https://www.msci.com/blog-posts/the-pressure-of-the-crowd/02505396213> where MSCI researchers applied MSCI’s own security level crowding model to various thematic indexes, and found a level of crowding in “Efficient Energy” that was similar to what was observed in US tech in 1999. Our approach is different, but the results are corroborative.