Mesirow

Are ESG investing and portfolio alpha mutually exclusive?

While interest in sustainability as a portfolio objective is at an all-time high, many investors remain skeptical about its implications for return.

The approach we use for the Mesirow Analytic Fixed Income (MAFI) environmental, social and governance (ESG) strategy is designed to build portfolios that have strong sustainability characteristics while also potentially outperforming their benchmarks. The foundation of our portfolio construction process is our issuer selection model that emphasizes both "style factor" exposures and favorable ESG profiles.

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Style factors, including quality, value, size, momentum and carry – are variables linked to a company that tend to coincide with return premiums. These premiums are a reward for bearing risk, structural impediments, or behavioral biases.

Companies with high ESG scores tend to have exposure to several style factors. For example, a portfolio of companies with high ESG scores has a statistically significant tilt to the quality factor. More broadly, companies with high ESG scores show a strong correlation with several style factors that earn a premium over the market. This is not to say that ESG is the cause of the return premium. Rather, these style factors are sometimes concurrently present in companies with high ESG scores.

Portfolio construction that emphasizes exposure to these style factors and includes high ESG scores can provide both value enhancement (performance in excess of the market) and values alignment (a strong ESG profile).

ESG INTEGRATION

Issue Selection Model
↓
Portfolio optimizer
↓
Style factor exposure → Value enhancement (Benchmark plus returns)
ESG factor exposure → Values alignment (Sustainability)

Source: Mesirow Analytic Fixed Income

Companies with high ESG scores tend to have exposure to several style factors.

Mesirow Analytic Fixed Income portfolio construction

Our Corporate Bond Issue Selection Model seeks to predict the relative performance of investment grade corporate bonds by prioritizing exposures to style factors such as momentum, quality, carry and value at the security level. ESG is included in a basket of fundamental factors that help us evaluate bonds at the issuer level.

We construct portfolios using an optimization framework, which seeks to satisfy various exclusion and constraint conditions while maximizing an objective function such as expected return, tracking error and turnover rate.

In designing our ESG strategies, we integrate ESG into the optimization process through a combination of tilting, screening, and maximization:

- **Tilting:** We can tilt our portfolio towards bond issues with higher ESG scores. We achieve this by adding a constraint on the average ESG score. For example, we may set the constraint that the average ESG score of the portfolio is at least 10% higher than that of the benchmark portfolio.
- **Screening:** We can screen out certain bond issues or issuers based on ESG score or other sustainability criteria. For example, we may exclude 20% of the bond universe with the worst ESG scores. Another option is to screen companies based on carbon emissions, freshwater stress, or climate change vulnerability. Business involvement screens, if desired, are applied at this stage as well.
- **Maximization:** We can maximize ESG score exposure by assigning a positive weight for ESG score in the objective function. By assigning positive weights for both ESG score and the Issue Selection Score, we design ESG strategies with both the potential for positive excess return and higher exposure to ESG. We can achieve relative emphasis on ESG exposure versus expected return by changing the relative weights assigned both.

We designed Mesirow Analytic Fixed Income's ESG strategy to be:

- **Genuine:** Correctly price environmental, social and governance risks and opportunities while considering the "3 Ps" of people, planet and profit.
- **Unique:** Use an optimization framework that efficiently integrates the comprehensive data associated with ESG, but also gives us the ability to customize each portfolio to meet specific client objectives.
- **Effective:** Build portfolios with companies that have both high ESG scores and returns above the benchmark.

Data information

Table 1 shows the results of our Issue Selection Model's backtest performance for our Corporate Only Portfolio. The portfolio including an ESG overlay has very similar excess return, tracking error and information ratio, demonstrating successful ESG integration while meeting our alpha objectives. In the base case the ESG portfolio will screen out the lowest 20% of issuer ESG scores by industry, while building a portfolio with a weighted average ESG score at least 10% greater than the benchmark.

Table 2 provides key metrics from the MSCI ESG Portfolio Summary Report, comparing the MAFI Core ESG model portfolio with the Bloomberg US Investment Grade Corporate Index. The portfolio has a higher industry adjusted ESG score, a higher quality score and a full letter grade better ESG rating. The portfolio holds more industry leaders and less laggards. Issuers with positive momentum, held in the portfolio, significantly exceed the benchmark while having only a modestly higher number of negative momentum issuers. Carbon Intensity, Severe Controversy and Governance exposures are all favorable versus the benchmark.

TABLE 1: **ISSUE SELECTION BACKTEST RESULTS | JANUARY 2012 – JUNE 2022**

MAFI Corporate Only Portfolio	Excess Gross Returns	Tracking Error	Information Ratio
Without ESG	1.51%	0.87	1.74
With ESG	1.29%	0.88	1.47

Source: Mesirow Analytic Fixed Income. **Past performance is not indicative of future results.** Performance information contained in this table is hypothetical and clients should not expect to achieve same or similar results and may achieve materially different results. In the results shown, the portfolio was constructed to the bottom 20% of ESG scores by Global Industry Classification System (GICS), while achieving a weighted average ESG score for the portfolio of at least 10% higher than the Bloomberg U.S. Investment Grade Corporate Index. Due to lower coverage rates of ESG scores in the historical data, issuers with no ESG scores are assigned an average ESG score.

Past performance is not indicative of future results. There can be no assurance that portfolios incorporating an ESG strategy will be profitable or will equal previous or other results and materially different results may occur. The framework discussed in this presentation is hypothetical and does not represent the investment performance or the actual accounts of any investors. The securities in the hypothetical portfolios were selected with the full benefit of hindsight, after their performance over the period shown was known. The results achieved in our simulations do not guarantee future investment results. Please refer to the disclosure at the end for additional, important information.

TABLE 2: **ESG PORTFOLIO SUMMARY REPORT**

	ESG			Holdings				Environmental	Social	Governance	
						Momentum					
	Score	Quality	Rating	Leaders	Laggards	(+)	(-)	CO2e/$ Sales	Controversy	Leaders	Laggards
Portfolio	6.82	9.73	AAA	33.40	0.00	49.20	6.60	161.50	0.00	34.90	7.80
Benchmark	6.15	8.30	AA	26.10	4.00	44.00	5.20	293.80	4.40	28.40	9.40
Difference	11.80%	17.23%		7.30	(4.00)	5.20	1.40	-132.30	(4.40)	6.50	(1.60)

As of May 5, 2022 | Source: Mesirow Analytic Fixed Income and MSCI ESG Manager Portfolio Summary Report. **Past performance is not indicative of future results.** Performance information contained in this table is hypothetical and clients should not expect to achieve same or similar results and may achieve materially different results. The back test does not apply screening and tilting on metrics related to carbon emissions, because historical data for these metrics are not available.

Conclusion

For us, the goal of ESG integration is to build a portfolio of companies with high ESG scores, while maintaining positive exposure to historically rewarded style factors. This combination provides investors with the opportunity to invest in a portfolio designed to potentially outperform the benchmark while emphasizing sustainability as a valued characteristic of the companies they invest in.

For more information regarding Mesirow Analytic Fixed Income customized ESG strategies, please contact Jim DeZellar, CFA, Managing Director at jim.dezellar@mesirow.com or 312.595.8660.

About Mesirow

Mesirow is an independent, employee-owned financial services firm founded in 1937. Headquartered in Chicago, with locations around the world, we serve clients through a personal, custom approach to reaching financial goals and acting as a force for social good. With capabilities spanning Global Investment Management, Capital Markets & Investment Banking, and Advisory Services, we invest in what matters: our clients, our communities and our culture. To learn more, visit mesirow.com and follow us on LinkedIn.

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The Bloomberg U.S. Aggregate Index (formerly named Bloomberg Barclays U.S. Aggregate Index) represents securities that are SEC-registered and U.S. dollar denominated. The index covers the U.S. investment grade fi xed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. Indexes are unmanaged. It is not possible to invest directly in an index.

Business Involvement Screening is a screening service that enables institutional investors to manage environmental, social, and governance (ESG) standards and restrictions. The screening service supports investors looking to identify all global publicly traded companies and select bond issuers that are involved in activities such as the production of controversial weapons or tobacco products, or those that violate religious screening mandates such as Catholic or Islamic Values.

Carbon Risk measures exposure to carbon intensive companies. It is based on MSCI Carbon Metrics, and is calculated as the portfolio weighted average of issuer carbon intensity. At the issuer level, Carbon Intensity is the ratio of annual scope 1 and 2 carbon emissions to annual revenue. Carbon Risk is categorized as Very Low (0 to <15), Low (15 to <70), Moderate (70 to <250), High (250 to <525), and Very High (>=525).

ESG Quality Score measures the ability of underlying holdings to manage key medium to long-term risks and opportunities arising from environmental, social, and governance factors. It is based on MSCI ESG Ratings and is measured on a scale of 0 to 10 (worst to best). The distribution of scores is based on the universe of approximately 28,000 funds included in MSCI ESG Fund Metrics.

ESG Ratings Distribution represents the percentage of a portfolio's market value coming from holdings classified as ESG Ratings Leaders (AAA and AA), Average (A, BBB, and BB), and Laggards (B and CCC).

ESG Ratings Momentum represents the percentage of a portfolio's market value coming from holdings that have had an ESG Ratings upgrade, and those with a downgrade, since their previous ESG Rating assessment.

ESG Scores are assigned to companies, while ESG Quality Scores are assigned to portfolios. Companies are assigned an ESG rating based on their final industry adjusted ESG score, which in turn is based on the weighted average key issues scores.

Governance Risk represents the percentage of a portfolio's market value coming from holdings classified as Governance Leaders (global percentile of 76-100%), Average (26-75%), and Laggards (0-25%).

The **MSCI ESG Portfolio Summary** is a two page report designed to assess ESG integration in a simple and intuitive way, featuring key portfolio level ESG signals, including: MSCI ESG Ratings Quality, Distribution and Momentum, Carbon Risk, Reputational Risk, and Governance Risk

Reputational Risk represents the percentage of a portfolio's market value coming from holdings involved in very severe controversial events. It is based on MSCI ESG Controversies. Portfolio level Reputational Risk is categorized as Very Low (0%), Low (>0% to <1%), Moderate (1% to <5%), High (5% to <10%), and Very High (>=10%).