S&P Dow Jones Indices

A Division of S&P Global

FA Talks

The Past, Present, and Future of ESG Strategies

Glenn Ambach, CFA
Managing Director and
Co-Chief Investment Officer
Efficient Market Advisors,
a Business of Cantor
Fitzgerald Investment Advisors

FA Talks is an interview series where industry thinkers share their thoughts and perspectives on a variety of market trends and themes impacting indexing.

Efficient Market Advisors (EMA) is a pure ETF strategist firm dedicated to providing balanced asset allocation strategies using ETFs. EMA was founded in 2004, giving it one of the longest track records in the industry. In 2017, EMA was purchased by Cantor Fitzgerald and now operates as a business within the firm's asset management unit, Cantor Fitzgerald Investment Advisors. The firm launched ESG versions of its strategies in 2018, making it one of the first agencies to do so.

S&P DJI: Why launch ESG strategies back in 2018 before they had more mainstream adoption?

Glenn: As an asset manager, one of the most appealing aspects of incorporating ESG is that it differentiates our firm as well as the advisors that utilize our strategies. It also presents the opportunity to be a leader both within the industry, as ESG is adopted more and more, and with clients who are increasingly demanding investment firms incorporate ESG considerations.

In terms of demand for ESG investing, we have seen a big shift toward incorporating ESG investing at the institutional level. We have also seen large inflows into ESG funds at the retail level. Historically at the retail level, demand was most often associated with women and millennials. For example, according to a 2017 report from the Morgan Stanley Institute for Sustainable Investing,[1] 84% of women and 86% of millennials were interested in ESG investing. However, since launching our strategies, we have seen an increase in interest across all demographics, and I think ESG investing is something that appeals to a wider audience of investors. For example, we now have a nearly equal amount of women and men who choose our ESG strategies, with a distribution of clients across all age groups — in fact, most are over 40 years of age, indicating strong interest among older generations.

1 "Sustainable Signals, New Data From the Individual Investor," Morgan Stanley Institute for Sustainable Investing, August 2017.

2 Friede, Gunnar, Busch, T., and Bassen, A. "ESG and financial performance: aggregated evidence from more than 200 empirical studies," December 2015.

From a portfolio perspective, there has been growing evidence of the potential for the financial benefits of incorporating ESG analysis. Research[2] has shown companies that score high in ESG factors had reduced costs, increased efficiency, lower risk of fines, and lower cost of capital, which may contribute to improved corporate financial and investment performance.

S&P DJI: In the past, what were some of the challenges of ESG investing?

Glenn: Unfortunately, prior to when we started our ESG strategies a couple years ago, we couldn't build a complete, balanced asset allocation because there weren't enough ESG ETFs that covered enough asset classes and did so at a low cost, as the few ESG ETFs available had high expense ratios. I think of the evolution of ESG ETFs similar to that of the ETF industry as a whole when our firm was started in the early 2000s. At that time, there were enough ETFs to build out a basic allocation. Over time, more and more ETFs were launched, and now there are strategies available in almost any niche a client may desire. Similarly, over the last few years, thanks to the adoption of ESG principles by firms like S&P DJI, indices incorporating ESG criteria licensed to products like ETFs have expanded, bringing down expenses to where we were finally able to build out a full allocation using ESG ETFs at a low cost. From here, I think the amount of ESG index strategies available is going to accelerate much quicker.

S&P DJI: How do you construct your ESG strategies?

Glenn: The process of constructing our strategies is similar to that of large institutions, such as pensions and endowments, but provides a better solution for advisors to use with their clients. We start just as an institution would, with long-term strategic allocations across asset classes. Next, we review economic and market data to make tactical shifts to the asset classes, such as overweighting stocks over bonds, U.S. over international equities, or large caps over small caps. Then, instead of employing a manager or multiple managers within an asset class, which is prohibitive for many individuals, we gain diversified exposure to the asset class by utilizing ETFs.

For our ESG strategies, we start with the same strategic allocations across asset classes and make the same tactical asset allocation decisions, but utilizing ESG ETFs. When looking at ESG ETFs, we look at the same criteria as we normally would, including expenses or beta to the desired asset class. Then we take the process a step further, giving special consideration to how the ETF and the underlying index implement ESG criteria. For example, whether the ESG index maintains sector or regional composition, and what its tracking error is to the non-ESG index. We will also look at the ETF's ESG score and the issuer's ESG commitment, among other things.

S&P DJI: Has your firm experienced a trade-off in performance when incorporating ESG into portfolios?

Glenn: We've had these strategies for a little over two years now, and when we perform attribution on the specific strategies, we find that the ESG ETFs that we have used for each asset class have outperformed their non-ESG counterparts with lower risk. In addition, the blended expense ratios of the ESG strategies are comparable to the non-ESG strategies.

The narrative that companies that have good environmental records, treat their employees well, and have good governance practices tend to outperform is making an impact on portfolio risk and return. The great thing is that now we can quantify the impact that our specific ESG portfolios are having on ESG metrics as well. For example, according to DWS's KPI report for their large-cap ESG fund, by switching from the S&P 500® to the S&P 500 ESG Index, fund holdings had 21% less carbon emissions, which is the equivalent to eliminating the emissions of eight cars on the road for a year. So, in this case, we could get an equal or better risk/return profile in these asset allocation strategies while also feeling good about how we invest.

S&P DJI: What are some areas of ESG investing that need further improvement in your opinion?

Glenn: I think the two things that need further improvement are already happening but need to continue to evolve.

The first would be specific to how we invest using ETFs: more products covering more areas. Equity is well covered and has been the main focus thus far. However, it would be nice to get more granular by sector, industry, or other niche areas. Fixed income has the basic building blocks but needs more development.

The second would be standardization and reporting. ESG investing started with no real standards, and reporting differed from place to place. As ESG investing has evolved, I think the industry is coalescing around common standards and reporting practices. We also saw ESG reporting start at the company level. As we see with S&P DJI, it is now being applied at the index and fund level in ESG scores and the measurement of the impact of ESG indices. Reporting is now evolving further and beginning to be applied at the portfolio or strategy level.

S&P DJI: Where do you see the future of ESG strategies and investing going?

Glenn: Pressure from investors and other stakeholders such as employees and customers, as well as the growing evidence of the financial benefits of incorporating ESG criteria, will help accelerate adoption by companies to integrate ESG criteria into their processes. Reporting by companies will improve and become more widespread, leading to better transparency and data on ESG issues. This will also lead to greater regulation of ESG reporting, such as the recently enacted Sustainable Finance Disclosure Regulation by the European Union in accordance with their Sustainable Finance Action Plan.

Based on the growing evidence that incorporating ESG criteria may lead to better financial performance and potentially reduce risk, as well as investors' growing desire to make a positive impact with their investments, it's likely that investors will increasingly incorporate ESG criteria into their decision-making processes. As mentioned earlier, to meet this demand, index providers and product manufacturers such as ETF issuers should aim to continue to provide investment solutions that will drive further gains into assets that consider ESG criteria at both the institutional and retail level. We can already see these advancements beginning to take place — for example, according to the TrackInsight Global ETF Survey 2021, ESG assets rose to USD 174 billion with a record inflow of USD 87 billion in 2020. Assets are set to rise further, as 34% of respondents said they expect to increase their exposure to ESG ETFs by at least 5%, and an additional 14% stated they would increase their exposure to ESG ETFs by more than 20%.