For professional investors - Marketing communication - July 2024

ESG AND PERFORMANCE

WHAT IMPACT DO SUSTAINABILITY CRITERIA HAVE ON PORTFOLIO PERFORMANCE?

The effect on the performance of an investment portfolio of applying sustainability-based criteria to select stocks remains a topic of intense debate. Before assessing the impact, we note that environmental, social and governance criteria can be used to achieve different goals. Thus, outcomes vary depending on the sets of ESG criteria used for investment portfolios.

The results of the study we are presenting in this article show that outcomes do indeed differ depending on why and how sustainability criteria are chosen. We believe that being clear on this critical point adds to an understanding of sustainability-related investing.

We also note that while this study reviews three approaches in their own right, in practice various methodologies are applied in combination in a single portfolio. They are often complementary to the fundamental financial data shaping investment decisions.

A close look at three selected approaches to ESG

We assessed the impact of including as well as excluding stocks using three different methods (there may be others, but these are commonly used):

- *Excluding companies* using our criteria for responsible business conduct. This helps us as investors to avoid companies susceptible to reputational risk or breaches of regulations, or whose assets could lose value suddenly or unexpectedly because of innovation or changes in regulations ('stranded asset risk'). Examples are coal, unconventional oil & gas, tobacco businesses.

- *Ranking companies* on the basis of our selection of material environmental, social and governance (ESG) factors.[1] This helps us as investors to pick companies that score well on sustainability and exclude those that do not.
- *Qualifying companies* as sustainable investments.[2] We pick stocks that meet our definition of SI, including companies in our portfolios that contribute to an environmental or social goal, do no significant environmental or social harm and have good governance practices, and excluding those that do not.

Do investors lose out when we exclude or pick specific stocks by applying these criteria?

To answer this question, we applied the three approaches mentioned above to put together separate US, European, emerging market and global stock portfolios for a total of 12 portfolios.

Applied sustainability approach	Portfolio implications
• Companies *excluded* by our Responsible Business Conduct (RBC) policy[3]	*Exclusions* amount to about 6% of MSCI ACWI and MSCI USA stocks, 2% of MSCI Europe stocks and 7% of the MSCI Emerging Markets by market capitalisation
• Companies *ranked* by our selection of material ESG factors[4]	30% of the worst ESG ranked stocks in each sector were *excluded*
• Companies *qualifying* as SI[2]	In the portfolio, 100% was allocated to stocks that qualify as SI, amounting to 40% of the MSCI ACWI index, 39% of the MSCI USA, 54% of the MSCI Europe and 30% of the MSCI EM

The portfolios were reviewed and adjusted once a month.[5]

Performance was calculated over four calendar years (2020, 2021, 2022 and 2023) as the out- or underperformance of each portfolio versus standard benchmarks for US, European, emerging market and global stocks (known as the excess return):

- MSCI All Country World (ACWI) NR index in USD
- MSCI USA NR index in USD
- MSCI Europe NR index in EUR
- MSCI Emerging Markets (EM) NR index in USD.

The review period spanned four years, starting in 2020 since that was when we launched our ESG scoring methodology[4] for companies.

1 ESG assessments are based on BNPP AM's proprietary methodology which integrates environmental, social and governance aspects
2 Our methodology to identify Sustainable Investments as per the SFDR includes criteria related to the alignment of companies with the EU Taxonomy's climate objectives and climate-related Sustainable Development Goals, as well as with the objective of maintaining the global temperature rise to below 1.5°C; also see our 2023 Sustainability Report
3 Our RBC policy is available on our corporate website @ Sustainability documents - BNPP AM Corporate English (bnpparibas-am.com)
4 See ESG Scoring Framework - BNPP AM Corporate English (bnpparibas-am.com)
5 The portfolios were fully invested and constructed every month by reweighting stocks by market capitalisation after excluding stocks based on each respective set of criteria. Source: BNP Paribas Asset Management and MSCI. Calculations on 31 May 2024. For illustrative purposes only. Past performance is no guarantee of future performance.

Comparing the performance of three approaches

- *RBC-based exclusions* had a **negligible impact** on performance over the full four-year period. However, there was an effect on short-term performance: all four RBC portfolios did poorly in 2022 as rising oil prices boosted the energy sector, which is largely excluded from investment under this approach. Applying our policy, we do not invest in sectors such as unconventional oil & gas and coal.
- *ESG rankings* resulted in a **positive performance** versus the global, US and emerging market benchmarks despite a poor 2022 due to the exclusion of the strong oil & gas sector. For Europe, performance was flat, with better results over 2020, 2021 and 2023, but – again – underperformance occurred in 2022.
- *Including SI-grade companies only* led to **outperformance** across the board over the full period. For the global, Europe and emerging market portfolios, this approach made 2022 a difficult year. This was, however, not the case for the US portfolio. Applying our SI definition to a portfolio of emerging market stocks had a notably positive effect. Using this approach, a larger number of stocks are excluded than for the World, US and Europe portfolios.

Details of the results can be found in the tables below.

Do not tar all sustainable investment approaches with the same brush

When assessing sustainable investment approaches, investors should realise that these approaches do not all have the same goals. Some contribute more to the *risk* side of the risk-reward equation – by mitigating risk – while for others, the pendulum swings more to the *reward* side as they aim at improving returns.

Taking the risk-reward perspective, investors can regard our policy on responsible business conduct as a tool to first and foremost **mitigate risk** – its goal is to exclude investments more likely to create reputational risk or that are exposed to regulatory or stranded asset risk. The policy is used widely in our portfolios. Applying it means there is a smaller pool of stocks that we can invest in. While such a smaller opportunity set narrows the field from which we can harvest returns, the impact appears limited for the investment universes studied here, as mentioned above.

We believe ranking stocks using material ESG criteria helps us as investors to **make better-informed investment decisions and thus deliver potentially better risk-adjusted outcomes.** We expect this approach to contribute to a positive track record over time, but – as the above results show – there could be difficult years. ESG scoring is part of our company-wide policy of including ESG considerations in our investment analysis. This is in line with our commitments as the sustainable investor for a changing world.

Finally, applying our definition of sustainable investments helps us to include investments in our portfolios that are environmentally or socially beneficial and hence positive from a sustainability-focused point of view. The results of our study show this approach can **contribute to portfolio performance**, although again one should not expect this every single year. We have set the amount of SI investments at 100% of the assets for Sustainable Finance Disclosure Regulation (SFDR) Article 9 funds; for many of our Article 8 funds, the minimum percentage is often more than 10%.

Appendix

Comparing the impact of RBC-based exclusions, ESG ranking and sustainable investment criteria on the results of equity investment portfolios

MSCI All Country World

	2020	2021	2022	2023	Full period annualised
	Return				
index	16.8%	19.0%	-17.9%	22.8%	8.8%
	Excess return				
RBC	0.6%	-0.3%	-1.4%	0.9%	-0.2%
ESG	3.9%	1.5%	-2.0%	1.9%	1.0%
SI	4.5%	4.9%	-1.3%	0.3%	1.8%

MSCI USA

	2020	2021	2022	2023	Full period annualised
	Return				
index	21.4%	27.0%	-19.4%	27.1%	12.1%
	Excess return				
RBC	0.9%	-0.1%	-1.6%	1.5%	-0.1%
ESG	5.4%	1.6%	-2.5%	1.9%	1.1%
SI	2.9%	7.8%	0.4%	-0.5%	2.4%

MSCI Europe

	2020	2021	2022	2023	Full period annualised
	Return				
index	-2.9%	25.8%	-8.9%	16.6%	6.7%
	Excess return				
RBC	0.0%	0.0%	-0.7%	0.5%	-0.1%
ESG	1.2%	0.2%	-1.6%	0.5%	0.0%
SI	7.5%	2.4%	-3.5%	1.0%	1.7%

MSCI Emerging Markets

	2020	2021	2022	2023	Full period annualised
	Return				
index	18.7%	-2.0%	-19.7%	10.3%	0.7%
	Excess return				
RBC	0.5%	-1.1%	-0.8%	-0.7%	-0.6%
ESG	3.1%	0.4%	-0.4%	2.4%	1.2%
SI	11.9%	10.2%	-5.0%	2.7%	4.0%

Source: BNP Paribas Asset Management and MSCI. Calculations on 31 May 2024. For illustrative purposes only. Past performance is no guarantee of future performance.

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VIEWPOINT

BNP PARIBAS ASSET MANAGEMENT

The sustainable investor for a changing world