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Research Affiliates Says ESG Isn't an Investment Strategy — And That's a Good Thing

A deep dive into ESG-themed indices shows that they're all but indistinguishable from traditional benchmarks.

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Illustration by II

Even experts can barely pick up on the differences between the largest environmental, social, and governance indices and traditional cap-weighted benchmarks.

The top five ESG benchmarks, for example, look a lot like the Russell 1000 index in terms of holdings, valuation, and performance, according to the latest analysis by smart beta and asset allocation specialist Research Affiliates. The ESG indices have all placed huge bets on technology giants like Apple, Microsoft, and Alphabet, just like the traditional benchmark. All of the top ten holdings of the five ESG indices and the Russell 1000, are the same, except Johnson & Johnson, Berkshire Hathaway, and PayPal, according to the RA study.

In the report, Research Affiliates builds a good case that ESG is a set of investor preferences — and not an investment strategy.

The ESG indices do not stand out from traditional benchmarks when analyzed by popular valuation metrics, either. The price-to-dividend ratio, for example, clocks in at an average of 82.7 for Russell 1000 companies and ranges between 80.9 and 96.3 for companies in the ESG indices. The price-to-earnings ratio, price-to-cash flow ratio, and price-to-sales ratio also differ very little between the ESG indices and the benchmark. When it comes to performance, the five largest ESG indices and the Russell 1000 have generated almost identical returns over the past two-and-a half years, according to RA.

The fact that ESG indices are sometimes indistinguishable from traditional benchmarks has led RA researchers to dismiss ESG as an investment strategy. A strategy, they argue, should include "a set of decisions that governs allocation and timing of capital among the portfolio's positions." But existing ESG index providers have merely made minor adjustments to their cap-weighted counterparts to incorporate their own ESG preferences or desires.

"It's just another version of a normally cap-weighted strategy," Brent Leadbetter, partner at Research Affiliates, told *II* in an interview. "For all intents and purposes, it's the same portfolio, just with some minor exclusions."

"We believe the term 'ESG strategy' is generally a mischaracterization," the report said. "While some managers use ESG measures to identify risks and opportunities, more often ESG metrics merely reflect investor preferences incorporated in an existing strategy."

Yet the fact that an investment focus on ESG has barely made any impact on portfolio performance can be a good thing, Leadbetter argued. That means investors can exclude certain holdings without materially changing the performance of their portfolios. For those who want to reduce exposure to carbon-intensive sectors, for example, they can choose a cap-weighted ESG index that excludes coal companies without worrying about underperformance.

If ESG is a preference not a strategy, investors then can apply it to any investment discipline, the RA study noted. Investors who want to focus on environmentally sustainable companies, for instance, can incorporate those into cap-weighted strategies, or they can layer those into factor-tilted strategies, such as low volatility, quality, or momentum, according to Leadbetter.

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