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Trend Aggregation: The New ESG Landscape

Tuttle Tactical Management

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Definition

Environmental, Social, and Governance (ESG) practices have become increasingly popular as consumers and investors seek to better gauge how companies respond to issues relating to sustainability, climate change, social equality, and corporate practices.

Prior to the popularity of ESG, the term "socially responsible investing" (SRI) referred to the ways in which companies sought a positive impact in the world. Related investments tied to SRI were generally selected based on this potential impact and not necessarily on whether they would generate positive returns. Unfortunately, many companies had not yet adopted the SRI practices behind the ESG movement, resulting in a generally bad choice for investors: either they could invest in socially responsible funds and get potentially poor performance or they could invest in funds that weren't socially responsible and capture potentially better performance.

Defining ESG Practices (cont.)

Now, ESG practices are more popular among companies, which means not only can an investor participate in a socially responsible portfolio and get just as good performance as they'd get from a non-socially responsible one, there's some research to suggest that socially responsible companies actually do better than not. Even if they don't today, they may in the future because more people are asking for it. Additionally, when pension funds turn for various professions (e.g., teaching, police, and firefighters) and pension managers are told they want something socially responsible, companies that are socially responsible may trade at a premium because those are the companies money managers will be urged to include.

Example ESG Focus Areas

Environmental:	Climate Change, Scarcity of Natural Resources, Waste and Pollution, Deforestation, Ecological Footprint, Biodiversity
Social:	Health and Safety, Labor Standards, Community Impact, Diversity and Inclusion, Gender Equality, Employee Relations
Governance:	Board Structure and Diversity, Executive Pay, Tax Transparency, Political Lobbying, Shareholder Rights, Anti-Corruption

The ESG Portfolio Landscape

All things being equal, a concentrated portfolio should outperform a portfolio that has 200-300 stocks in it. But if one looks at the ESG landscape, there are many index products, which potentially have hundreds of stocks in them. If one of these index products includes a few stocks that are performing poorly, that product is limited in its ability to sell them. In fact, they may be present in the portfolio until the next rebalance date, which could be quarterly, semi-annually, or even annually. There's also the possibility that the portfolio may have to include the stocks forever if they still meet the ESG criteria to be in the respective index. So it's not practical to have a concentrated portfolio in an index product like this.

The ESG Portfolio Landscape (cont.)

Applying a trend aggregation or tactical approach, on the other hand, opens the potential for the models for the individual stocks to get out at any time. Furthermore, if the core basket of stocks can change on a semi-frequent basis, such as monthly, one can have a more concentrated ESG portfolio.

Because Trend Aggregation involves incorporating multiple, uncorrelated methodologies and return streams, it is important to also consider how this approach could be applied to an ESG portfolio in ways that preserve its socially responsible composition.

In addition to having a concentrated portfolio comprised of ESG-qualified equities, one could include the the ability to go to cash and to incorporate a volatility hedge, such as VIX, which, while not a company, per se, could be seen as a neutral option that doesn't compromise ESG principles.

One reason why VIX could be an effective hedge is because of its general asymmetrical return stream. When one is right and they hold VIX, they generally make more money than they lose when they're wrong. Additionally, the holdings of a hedge like VIX could be on a sliding scale, wherein one can move up in VIX, move down, or have no VIX. From a tactical perspective, what's important is that one has the ability to go into VIX and the ability to move on a dime and get into a decent amount of VIX per day to hedge the equity risk in a portfolio.

Even if one builds in a few hedges, a tactically managed ESG portfolio could still feel like a familiar ride[1] to investors. Given the cultural shift toward being more socially and environmentally conscious and responsible, more companies are adopting ESG principles, which can drive investment returns in ways that may not have been common in decades past. In the past, early SRI clients may have been content with lower returns due to the fact that their investments reflected their ethical and social values. Now, it is increasingly possible for investors to seek ESG products that are 1) consistent with their beliefs and 2) profitable.

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[1] **The Familiar Ride —** One aspect of managing a portfolio involves managing your experience vs. your expectations. The Familiar Ride can look similar to this: you go home, check the news, and see the market is down. You look at your account and see you've lost money. The next day, the market is up. You look at your account and see you've made money. Now, you don't necessarily want to manage for this, but it's a concept to be cognizant of, especially in a post-coronavirus economy where the "market" may or may not always facilitate this familiar ride. Rather, it's important to manage your experience and be aware of how emotions can potentially drive decisions. When emotions go up, especially during drawdowns, it's important to recognize where those emotions are coming from. A few things to note: you are likely to remember your high water mark just as you're likely to react to your portfolio's worst month, even if your portfolio is still up for the year. Experience is lived truth, and it's critical to understand how a certain perspective can form from a variety of experiences.