WESTFIELD
CAPITAL MANAGEMENT

September 2021

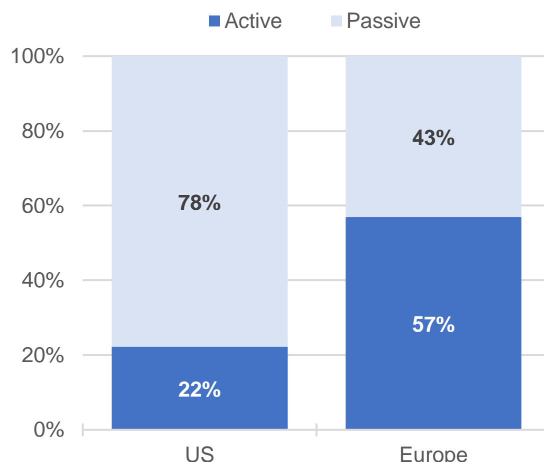
Active's ESG Advantage

Executive Summary:

- The inherent characteristics of ESG data make it uniquely challenging to apply a rigid, mechanistic approach for interpretation and investing.
- We believe active approaches are advantaged by their ability to leverage a variety of inputs, including management access and engagement, to inform their forward-looking views.
- As the market matures and the capabilities of asset allocators conducting ESG due diligence increases, we believe the merits of an active approach to ESG analysis will become more obvious and asset flows should reflect that conclusion.

The growth of sustainable investing, often referred to as ESG in common vernacular, has been particularly noteworthy of late, with both active and passive approaches garnering headline grabbing asset flows. While we think there is a role to play in the marketplace for passive strategies at large, namely cheap and liquid beta exposure, the characteristics of ESG data and analysis create inherent difficulties for algorithmic passive approaches. In these early days of accelerating adoption in the U.S., it should be no surprise that we have seen flows skew towards passive approaches which don't require a sophisticated evaluation framework prior to allocating capital. As the market matures, we expect the merits of an active approach to be both better understood and appreciated, much like in the more mature European marketplace where most flows go to active funds (figure 1). In the sections that follow we will break down the arguments for why we believe active investing is better positioned for assessing risk and opportunity in the sustainable investing market segment.

Figure 1: Sustainable Fund Flows to Active vs. Passive in Europe and the U.S.
Trailing 12 months, shown as a percentage of total flows

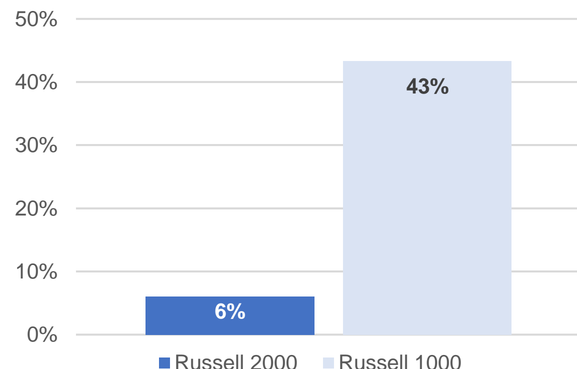


Source: Morningstar, as of 7/31/21

Unique Data Requires Unique Analysis

Central to the debate about the optimal approach to sustainable investing is the nature of the data itself, which is often qualitative, subject to interpretation, and not uniformly reported by all companies. These characteristics make it uniquely challenging to analyze in a mechanistic way. Interpretation and judgement is often required to decipher between a problematic data point or omission, and a result appropriate for a given business of its size and sector. Uneven information is especially problematic as you move down the capitalization spectrum where a majority of companies are still building their ESG reporting capabilities and sustainability teams, as shown in figure 2. Rigid and algorithmic approaches are incapable of the nuanced analysis required by imperfect data sets as seen with ESG information.

Figure 2: Percent of Companies Reporting to Carbon Data Project in Large Cap vs. Small Cap



Source: Carbon Data Project, as of 8/31/21

3rd Party Data Core to Passive

Passive strategies have often turned to 3rd party ESG data providers as the tool by which they determine

inclusion in their indexed products. The low correlation between 3rd party ESG scores and the wide range of inputs that determine the scores, as shown in Figure 3, illustrates the pitfalls of relying on such a mechanistic approach because these scores, often times in isolation, form the basis for inclusion or exclusion. Depending on the underlying data driving the index inclusion decision, the resultant portfolio can vary widely because the ratings assigned to the same company by different providers can vary so widely. We would argue that a better approach is to use a variety of sources to understand key ESG issues, how they are being addressed, and how they impact a company's ability to generate shareholder value going forward rather than be captive to a single source of information.

Figure 3: Correlation of 3rd Party ESG Ratings & Metric Count

Provider	Reuters	S&P	Sustainalytics	MSCI
Reuters	100%	62%	67%	38%
S&P	62%	100%	67%	38%
Sustainalytics	67%	67%	100%	46%
MSCI	38%	38%	46%	100%
Metric Count	178	100	175	125

Source: Matrix: MIT Sloan School of Management, as of 8/15/19; Metric Count: Goldman Sachs Global Investment Research, as of August 2021

Note: ESG ratings evaluate companies on a variety of metrics pertaining to environmental, social, and governance matters. Methodologies and metrics differ amongst providers.

Importance of ESG Improvement to Alpha

An often-overlooked area that has been shown to be a key contributor to relative performance gains (such as in Figure 4) is the group comprised of low ESG scoring companies that are making progress improving their operations and ratings over time. Passive approaches often omit these low scoring stocks, systematically excluding them from client portfolios regardless of any directional improvements that may be underway. Some of these companies may not yet see the wisdom of a focus on sustainable considerations, unwilling to change or adapt their businesses as needed, but others are captured in this group simply because they are just beginning to develop their approaches to ESG as their businesses grow. As shown below in Figure 4, companies in the lowest scoring group with the highest rate of improvement produced the best relative returns on an equal weighted basis over the three-year period from January 2018 to January 2021. Interestingly, the opposite is also true, whereby the highest-ranking companies with little to no improvement produced the lowest relative returns. Passive funds undoubtedly have exposure to this high ESG performing group but are unlikely to give as much consideration to the opposite end of the spectrum. We would argue that an active manager can find opportunities within this group that are ignored by passive funds.

Forward-Looking vs. Historical Perspective

Another critical dynamic to appreciate when comparing the two approaches is the emphasis placed on forward-looking views relative to historical information. Passive funds by nature are momentum indices driven inherently by backward looking information: the largest positions are those that have performed the best in the past instead of those that are expected to perform best in the future. When adding to the mix that index construction for passive ESG funds is heavily impacted by backward looking 3rd party ratings, this becomes even more pronounced. As is the case with earnings, the forward-looking view is often more important to the future stock performance than what has transpired in the past, and the same is true for ESG factors where it is critical to know what the company's forward strategy is on ESG topics, not just where it has been. The active approach incorporates forward looking views on the development of ESG reporting, regulation of E, S, and G topics across the marketplace, and other pertinent forward looking industry developments. Reported results are critical to know, but they are just one piece in the mosaic of information needed to create an informed forward outlook.

Figure 4: ESG Ranking & Momentum Quintiles (Jan 2018 to Jan 2021)
Equal weighted average relative returns for all constituents of the S&P 500 relative to the overall index return

Equally Weighted Average Relative Returns (USA)		ESG Momentum Quintiles				
		Q1 (Highest ESG Momentum)	Q2	Q3	Q4	Q5 (Lowest ESG Momentum)
ESG Scores (1Y Lagged)	Q1 (Highest ESG Score)	0.3%	0.9%	-4.7%	-2.4%	-5.3%
	Q2	-1.9%	3.6%	0.5%	0.2%	-2.0%
	Q3 (Lowest ESG Score)	4.3%	2.3%	2.1%	-1.5%	-1.6%

Source: Bernstein, Sustainalytics, Bloomberg, as of 4/20/21

Management Access is a Critical Tool

The importance of management access cannot be overstated within the world of investment management, and that access is of even greater importance when layering in ESG analysis. This access creates a forum to communicate ideas, influence outcomes, and more deeply understand business opportunities and risks in an evolving ESG landscape. In fact, the improved access and dialogue that can be achieved by engaging with management teams on these long-term issues is one of the key benefits of integrating ESG into an investment approach. Passive funds do not have that advantage, nor do the 3rd party rating providers whose scores play a critical role in determining index inclusion. They also do not have the option to sell a company's stock should the manager be unhappy with the direction of the business or management's willingness to engage on certain topics. This leverage is key to the proper working relationship between company management and shareholders, and ensures that incentives are aligned appropriately.

Conclusion

Both active and passive ESG strategies have grown in the marketplace and both will continue to play a role going forward. In our view, passive ESG strategies are an improved option relative to their pure index siblings, but as we have laid out, we believe they lack the inherent characteristics needed for optimal outcomes. The allure of lower fees is overshadowed by the rigidity of their approach to stock selection and their significant reliance on a single source of information provided by 3rd party ESG ratings providers. Active approaches, on the other hand, can leverage a variety of inputs, including management access and engagement, to inform their forward-looking views and ultimately their portfolio construction. In this way, active is playing the game ahead of us, while passive is playing the game that just ended. As the capabilities of asset allocators conducting ESG due diligence increases, we believe the merits of the active approach will become more obvious. In our view, the early adopters that opted for a passive approach "placeholder" while they ramped up due diligence capabilities may very well shift allocations into higher impact active strategies, much the way the market has developed in Europe.

As always, we would happily elaborate further on our views. Please contact our Marketing team to continue the conversation (clientservice@wcmgmt.com).

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